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Business, Innovation and Skills
Committee

The Kay Review of UK Equity Markets and Long-Term Decision Making

Third Report of Session 2013–14

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written evidence*

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Business, Innovation and Skills Committee

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The Reports of the Committee, the formal minutes relating to that report, oral evidence taken and some or all written evidence are available in a printed volume. Additional written evidence may be published on the internet only.

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The current staff of the Committee are James Davies (Clerk), Amelia Aspden (Second Clerk), Peter Stam (Committee Specialist), Josephine Willows (Committee Specialist), Ian Hook (Senior Committee Assistant), Pam Morris (Committee Assistant), Henry Ayi-Hyde (Committee Support Assistant).

Contacts

All correspondence should be addressed to the Clerk of the Business, Innovation and Skills Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5777; the Committee's email address is biscom@parliament.uk

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Summary

The UK equity market

In 2010, only 11.5 per cent of UK shares were owned directly by individuals. In the early 1960s this figure was as high as 54 per cent. The major investment decisions which affect British companies are now taken by asset fund managers around the world who work for firms which control billions, often trillions, of pounds. We have heard that the rise of the institutional investor and the growth of intermediaries has been accompanied by a shift from 'owning' to 'trading'. The structure of the equity market has changed beyond recognition over the past few decades and regulation has not kept pace with it. Furthermore, there is a growing concern that asset managers do not behave in a way that benefits the long-term health of the companies in which they invest. At the heart of the issue is the incentives connected to the different links in the investment chain; from the owner, to the fund manager, through to the executives of the companies themselves.

The Kay review

Professor Kay's review of the UK equity market sought to improve long-termism in the market and to address the relationship between owners and fund managers. Currently this relationship is defined by short-term measurement of success at every stage. Players are encouraged to think ahead by only months, weeks or even days. Fund managers are expected to produce tangible results in very little time. This is as a direct result of the way the success of such managers is gauged. Fund manager pay and bonuses are benchmarked against the performance of other managers on a short-term basis and this feeds through to the information and behaviour expected of company executives. We make clear recommendations for the Government to bring about a cultural change in the incentives driving fund-manager behaviour to and develop a set of longer-term measures of success.

Mergers and acquisitions

Professor Kay's remit also included the issue of mergers and acquisitions, an area that our Committee has often reported on. Professor Kay recommended that the Government should take a more 'sceptical' view of the benefits of large takeovers and should be much more proactive in its monitoring of such activity. We recommend that the Government goes further. It should publish an assessment of the take-over regimes of other similar economies to learn about the impact that takeovers have had on their companies and economies; clarify what actions it will take over the next six months to be in a position to effectively monitor all merger activity in the UK; and produce a feasibility study which clearly outlines the risks and benefits of introducing a policy that will differentiate the voting rights of long-term owners and short-term traders during a takeover.

Financial Transaction Tax

The practice of High Frequency Trading (HFT) and the fact that shares are now traded and held for a matter of milliseconds epitomises the challenges faced in regulating the market. While there was support for such a Financial Transaction Tax, concerns were raised about

the practicality of implementing such a tax unilaterally. We recommend that the Government considers the viability, benefits and risks of a Financial Transaction Tax on HFT with the objective of changing the behaviour of very short-term investors.

Commitment to change

Professor Kay published his final Report in July 2012 and we have scrutinised both his Report and the Government's response to it. This Report follows in the wake of previous Reviews, particularly the work of Lord Myners in 2001. It is a huge disappointment that previous Governments have not implemented the recommendations of previous works nor have they kept regulation in line with the rapidly changing nature of equity investment. There is no point in commissioning a Review of the industry unless the Government is challenged to move forward and make radical changes to align the incentives facing every link in the investment chain. The Government has to deliver on the recommendations made by Professor Kay and the issues raised by his analysis. It must bring forward proposals to enhance the culture of long-termism, transparency and accountability.

1 Introduction

Our inquiry

1. In June 2011, the Secretary of State for Business, Innovation and Skills asked the renowned economist Professor Kay to review whether equity markets in the UK gave sufficient support to the key objectives of developing British companies' capacity for innovation, brands and reputation and the skills of their workforce. Professor Kay published his final Report in July 2012 titled the *Kay Review of UK equity markets and long-term decision making*. The Government Response was then published in November 2012. On 12 December 2012, we asked for submissions of evidence on the recommendations set out in the Kay Review and the Government's plans for their implementation.

2. We took evidence from seven panels:

- Professor John Kay, Chair of the Review of UK Equity Market and Long-Term Decision Making
- The Lord Myners CBE
- Catherine Howarth, Chief Executive Officer, FairPensions (now ShareAction), Christine Berry, Head of Policy and Research, FairPensions (now ShareAction), Simon Wong, Visiting Fellow, LSE and Partner, Governance for Owners, and Dr Paul Woolley, Head of the Paul Woolley Centre for the Study of Capital Market Dysfunctionalities
- Dominic Rossi, Global Chief Investment Officer, Fidelity Worldwide, Anne Richards, Global Chief Investment Officer, Aberdeen Asset Management, Harlan Zimmerman, Senior Partner, Cevian Capital, and Roger Gray, Chief Investment Officer, Universities Superannuation Scheme
- Anita Skipper, Corporate Governance Adviser, Aviva Investors, Steve Waygood, Chief Responsible Investment Officer, Aviva Investors, Neil Woodford, Head of UK Equities, Invesco Perpetual, and Chris Hitchen, Member of Kay Advisory Board Team and Chief Executive, Railpen
- Daniel Godfrey, Chief Executive, Investment Management Association, Guy Sears, Director, Institutional, Investment Management Association, Penny Shepherd, then Chief Executive, UK Sustainable Investment and Finance Association,¹ and Matthew Fell, Director of Competitive Markets, Confederation of British Industry
- Rt Hon Vince Cable MP, Secretary of State for Business, Innovation and Skills

We are grateful to all witnesses for their contributions to this inquiry and to all those who submitted written evidence.

¹ Penny Shepherd stepped down as Chief Executive of UKSIF in May 2013. She was succeeded by Simon Howard. Mr Howard has had opportunity to review the evidence that Ms Shepherd presented; which continues to represent the views of UKSIF.

The Government told us that the Kay Review was not a “list of detailed reforms” but rather “a framework for further work”.² This did not entirely tally with Professor Kay’s outlook; he said that the Review should “deliver the improvements to equity markets necessary to support sustainable long-term value creation by British Companies”.³ This remains to be seen, but it was clear that both Professor Kay and the Department agreed that “a sustained commitment to reform from Government, regulators and market participants” was needed to successfully reform the equity markets to the benefit of both its users and the economy as a whole.⁴

2 Ev 86

3 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 9

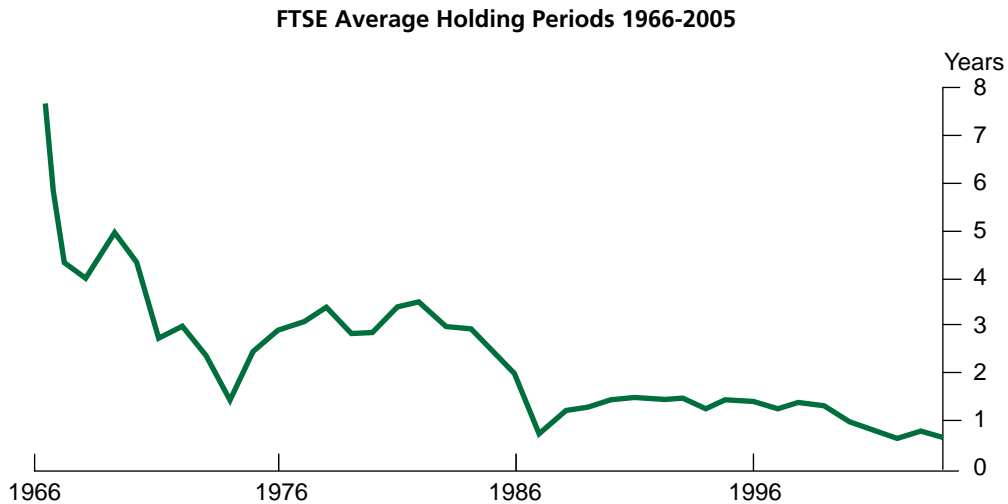
4 Ev 86

2 Background

Structure of the equity market

3. The rise of the institutional investor has been a significant evolution of the equity market in past few years. However, it has been accompanied by, and often linked to a decline in engagement and a rise in both short-termism and foreign owners. To understand the structure of the equity market, Aviva plc cited evidence about the rise in short-termism:

The Bank of England's Andrew Haldane has highlighted the sharp decline in average holding periods for UK equities since the mid-60s from a period of almost 8 years to just 7½ months in 2007, a trend that is reflected in the US and other international equity markets:



About two thirds of the turnover in UK equities is accounted for by hedge funds and high frequency traders.⁵

4. The market has been so distorted and complicated, the phrase ‘owner’ is no longer clear in its usage. Indeed, Professor Kay writes:

The term “share ownership” is often used, but the word “ownership” must be used with care. It is necessary to distinguish:

- Whose name is on the share register?
- For whose benefit are the shares held?
- Who makes the decision to buy or hold a particular stock?
- Who effectively determines how the votes associated with a shareholding should be cast?
- Who holds the economic interest in the security?⁶

5 Ev 99–100

6 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 3.12

5. The decline in individual investors has also been accompanied not only by a rise in institutional shareholders but also by a significant rise in foreign owners of UK equities. In 1963 only seven per cent of UK equities were held by owners outside of the UK. In 2010 that figure had risen to 41.2 per cent.⁷

Shareholder engagement

6. At the heart of Professor Kay's Review of the market was the question of engagement by shareholders. However, as he said in his Review, this is not simply a matter of volume:

The issue that concerns us is not whether there is too much or too little shareholder engagement. [...] Shareholder engagement is neither good nor bad in itself: it is the character and quality of that engagement that matters.⁸

7. Our witnesses from the sector agreed with this principle but argued that good engagement was hard to define. For example, Harlan Zimmerman, Senior Partner at Cevian Capital, was keen to point out the common mistake of confusing 'engagement' with 'voting':

[Voting] is a form of engagement that is very measurable, but it is not necessarily very meaningful if the objective is to steward the companies and improve them, as opposed to stopping them from doing bad things.⁹

This view was echoed by Neil Woodford, Head of UK equities at Invesco Perpetual:

There can be a disproportionate focus on voting as representative of your corporate engagement. In the environment that I experience day to day in the UK, corporate engagement is a bit like an iceberg. The bit that you can see above the surface is your voting record, but the vast bulk of your engagement is actually below the surface. It is not obvious how you engage or when you are engaging.¹⁰

He went on to explain that successful reform would be achieved only when shareholders voted with their voices and not with their feet, by acting like 'owners' not 'traders':

If you believe that at the first disappointing piece of news or the first opportunity you can exit the shares and move on to something else, then you will never think like an owner, and therefore you will not be actively engaged with that business. Ownership is crucial—a sense of ownership on behalf of obviously the asset owners as well as the asset manager.¹¹

8. Dr Paul Woolley, Head of the Paul Woolley Centre for the Study of Capital Market Dysfunctionality, took a slightly different stance. He told us that in order for the Kay Review to be considered a success, the recommendations that came out of it needed to

7 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 31, table 1

8 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 1.30

9 Q 191

10 Q 226

11 Q 241

achieve a shortening of the investment chain in order to “tackle the issue of too many intermediaries between savers and the assets they own, and the cost of those layers”.¹² The Chartered Institute of Personnel and Development agreed and linked the growing number of intermediaries and increased complexity within the investment chain to a recent “nosedive” in “public opinion of big businesses”.¹³

12 Ev 165

13 Ev 137

3 Previous review of the market

9. The commissioning of the Kay Review was not the first attempt by a Government to examine and reform the UK equity market. In 2001, Lord Myners published his *Review of Institutional Investment in the United Kingdom* (the Myners Review).

10. In the introduction to that Review, Lord Myners gave the following description of his work:

The review does not seek to argue that the institutions whose investment behaviour it examines have some public interest responsibility to invest in certain ways. But it is a legitimate issue of policy concern to establish the extent to which institutions' approaches to investment decisions are:

- rational;
- well-informed;
- subject to the correct incentives; and
- as far as possible, undistorted.

The review also has a specific remit to investigate institutional investment in private equity, but its purpose in doing so is to determine whether there are unnecessary barriers to such investment which should be removed, not to promote such investment regardless of whether it is right for the institution concerned. Indeed, a sudden move by pension funds to increase their allocation to private equity without proper consideration and analysis would be both damaging to them and contrary to the spirit of the review's recommendations. Private equity requires a sustained long-term approach, not rapid entry and exit driven by short-term performance results or changing fashion.¹⁴

11. Lord Myners told us that the Kay Review was “very well argued” and identified the core issue which was “the emergence over the last 30 years of a transactional relationship between companies, investors and intermediaries, and the dominance of the financial intermediaries, matched by a steady erosion of trust as the basis for commercial relationships”.¹⁵ However he went on to argue that without Government action the Review would have little impact on the sector:

I do not think that the Professor's report will add a jot or tittle to the prosperity of the UK economy and the success of our businesses.[...] The industry's response to Kay is, I think, one of considerable comfort. It might be summed up with: “Move along, Sir. Nothing much to look at here”.¹⁶

12. Lord Myners made more than 50 recommendations to the then Government to implement change. However, little progress was made in the implementation of those

14 Lord Myners, *Myners Review of institutional investment: Final Report*, March 2001, page 4, para 5

15 Q 83

16 Q 83

recommendations. Lord Myners argued that the reason for this was that the Government had simply lacked the resolve to act:

I am very disappointed in the lack of progress after my report on institutional investment in 2001. It relied on the same statements on principles of best practice that Kay is continuing to rely on. I have come to the conclusion that there are some fundamental flaws in our current approach to corporate ownership.¹⁷

He went on to remind us that “there is a long succession of reports on these areas” and that “there is very little in Kay’s early chapters that represent any fresh and additional perspective on these issues”.¹⁸

13. Professor Kay’s remit appears to support that lack of progress. We asked the Secretary of State for assurances that the Government would act on the Kay Review. Although the Secretary of State acknowledged that “there is always a danger of nice reports that just never happen”,¹⁹ he assured us that this would not be the case with the Kay Review:

We are not letting the matter rest. [...] We have made it very clear that in the summer or autumn of 2014 we want to go back over what the Kay Review has recommended to make sure that these things are actually happening. We are also commissioning a group of independent people who will track these recommendations and see that they are being followed through.²⁰

14. In the 12 years since the Myners Review, little has changed in the role and actions of institutional shareholders. The recommendations and findings of the Kay Review cannot be ignored or diluted as we have heard the Myners Review was. The similarities between the remit of the Kay review and that of the Myners Review demonstrate that little progress has been made to reform the sector. It is therefore critical that they do not share a similar fate. The Government must play an active role to drive reform on implementation of Professor Kay’s recommendations. Our Report, therefore, concentrates on where that activity must take place.

17 Q 84

18 Q 84

19 Q 314

20 Q 314

4 Professor Kay's recommendations and implementation

Investors Forum

15. Professor Kay recommended:

An investors' forum should be established to facilitate collective engagement by investors in UK companies.²¹

He elaborated that he saw the Forum as an opportunity for collective action to help "improve the performance of a company". He concluded that "the more opportunity there is for people who collectively own 30, 40 or 50 per cent of the company to act together, the more offset we have against that particular freerider issue".²²

In its response to the Review, the Government accepted this recommendation:

The Government intends to ask a small group of respected senior figures from business and the investment industry to review industry progress, including that made by institutional investors on shareholder engagement, both collectively and individually, and to assess companies' perception of the extent and quality of this engagement. This review will complement the Government's progress report in summer 2014.²³

16. Daniel Godfrey, of the Investment Management Association, told us that the Forum could produce benefits in terms of sharing stewardship resources and combating over-diversification of portfolios:

The investors' forum could potentially be a way of helping with [over diversification]. I recognise that it is very hard to get a consensus amongst investors. [...] There are examples, for instance in Holland, of where organisations come together effectively to syndicate from the buy-side their research on stewardship and engagement and governance, so that you can spread the load across a broad number of investors.²⁴

17. BlackRock, which was in favour of the Forum in principle, outlined three challenges and principles that should be put in place alongside the Forum to ensure its success:

1. The new forum needs to cover topics/issues that go beyond the typical discussions currently conducted through the existing industry.

21 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 51, rec 3

22 Q 30

23 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.18

24 Q 281

2. The forum’s governance policies need to ensure confidentiality of the meetings and views expressed as this aspect will be the key determining factor of the forum’s effectiveness and ultimate success.
3. The governance policies and terms of reference also need to be designed to allow effective actions in a way which does not conflict with rules on market abuse and acting as concert party in view of a takeover bid.²⁵

18. A number of our witnesses saw practical difficulties in creating a successful Forum. Despite the positives noises from the Investment Management Association, several witnesses argued that there was no need for the Forum, as there were already other investor groups in place. For example, FairPensions (now ShareAction) told us that “it is unclear how this initiative will differ from previous and existing investor bodies, such as the Institutional Shareholders Committee”.²⁶

19. Standard and Chartered Bank argued for a cautious approach in setting the remit for any new Investor Forum:

Any new rules regarding Investor Forum membership, meetings, engagement, communication, reporting and rights would need to be carefully constructed to ensure that it is complementary to existing investor communication methods and does not replace the existing and highly successful Investor Relations activity.²⁷

The Association of General Counsel and Company Secretaries of the FTSE 100 also took a sceptical view, arguing that there was “nothing to prevent interested parties from establishing such forums now, which leads us to question whether there is really a need for this type of body”.²⁸

20. Neil Woodford questioned whether asset managers would take part in such a Forum:

Investors are not good at coming together and talking about investment issues. Corraling investors is a bit like herding cats. It is very difficult to get investors even to agree to meet on a particular subject, even if it is particularly egregious.²⁹

Furthermore, Chris Hitchen, of USS Investment, pointed out to us that investment managers were “scared to meet, because the FSA or Takeover Panel might be suspicious”.³⁰ Steve Waygood, from Aviva Investors, told us that collaboration of investors through a forum would not necessarily produce results, and would need monitoring and proper resource:

25 Ev 129

26 Ev 112

27 Ev 88

28 Ev 116

29 Q 244

30 Q 244

There is nothing de facto about a forum that means that collaboration will be more effective or efficient and lead to better portfolio decisions. Fora can be extremely bureaucratic and ossify our ability to engage; they do not always necessarily work well. The ones that work well are the ones that are well resourced.³¹

21. Albion Ventures LLP argued that individual shareholders should not be given a collectivised voice as it believed that “solidarity amongst investors was unnecessary and may even weaken the strength of the shareholder system, namely that shareholders vote and act as individuals”.³² This opinion was disputed, however, by Christine Berry of FairPensions (now ShareAction) who told us that any Investor Forum “would need to include representation from asset owners as well as asset managers”.³³ She went on to argue that it must not become “just another vehicle dominated and run by the trade associations, which would be very similar to the vehicles we already have”.³⁴ Lord Myners shared this view, and clearly told us that if the Forum became “dominated by trade associations” then it would undermine the whole purpose behind the Review, because “trade associations’ modus operandi is to protect the status quo. It is not to change things”.³⁵

22. Penny Shepherd, Chief Executive of the UK Sustainable Investment and Finance Association (UKSIF), set out the three key groups which needed to be involved:

Active managers of equities. As you say, they may be structured in different ways, but essentially they are people who make buy and sell decisions.

Engagement specialists who are engaging on behalf of passively tracked funds, so on behalf of index-tracked funds.

Asset owners have commissioned independent service providers to engage with companies on their behalf.³⁶

23. When we questioned the Secretary of State on the role and remit of the Forum and how it would counter the risks illustrated by the industry, he gave a hands-off response:

We do not have a departmental remit telling them what we think they should do; we think Kay gives enough guidance on that.³⁷

He went on to tell us that this approach also extended to funding:

We have envisaged that this is something the industry should be doing in its own interests and it should fund it. There has been an issue about levies. [...] There is an

31 Q 246

32 Ev 91

33 Q 148

34 Q 148

35 Q 83

36 Q 295 [extracts]

37 Q 339

issue about how they charge their members for it and how transparent that charge is.³⁸

24. The IMA, alongside the Association of British Insurers and the National Association of Pension Funds, have accepted the challenge to establish the Investor Forum. They have stated that the next stage of implementation is to set up a working group to consider practicalities and issues surrounding the Forum, which would report later this year:

The intention is to appoint the working group by the end of April and to ask it to report in the Autumn with any recommendations as to how collective engagement might be enhanced to make a positive difference.³⁹

25. The IMA has confirmed that this timetable stands and that the working group will report its findings by the end of November 2013.⁴⁰ We received evidence expressing frustration that this seemingly simple and specific recommendation had not been implemented so long after it was accepted. Lord Myners told us that:

I have often found in my professional career, and also in the work I have done on reviews, that I have been given too much time. I am now a great fan of saying, “Let’s get these reviews done quickly. You will get 90% of the answers in 30 days. You may get the last 10% if you make it 300 days.” That is why, if I were the Secretary of State, I [...] would have had that investment forum up and running.⁴¹

26. We put the criticism to the Secretary of State that, despite the recommendation being accepted in the Autumn of 2012, the Forum remained in concept form only. The Secretary of State conceded that that was “a fair criticism”,⁴² but gave the following warning:

If the forum has not happened in the autumn, when this steering group reports, I think you would have good grounds for coming to me and saying, “Why aren’t you chivvying these people along? The report’s been out there for a year or so. Why is nothing happening?” That would be perfectly legitimate.⁴³

27. We agree with Professor Kay and the Government that collective engagement is to the benefit of the equity market and UK businesses. However, we are concerned that the hands-off approach taken by the Government runs the risk that progress will stall. The Government has provided no remit, deadline or resource for the Investor’s Forum and the ‘working group’ to investigate the concept of the Investor’s Forum will not report until later in 2013. The Government has told us that it will publish an update on progress in the summer of 2014. We recommend that the Government outlines a clear timetable for

38 Q 343

39 Investment Management Association website, *Press release 26 March 2013: Investors to work together on collective engagement* [accessed 21 June 2013]

40 Investment Management Association website, *Investor Working Group on Collective Engagement* [accessed 11 July 2013]

41 Q 94

42 Q 342

43 Q 342

setting up the Forum before that point, engaging with different types of investors, along with milestones and assigned responsibilities for achieving this.

Fiduciary duty

28. Professor Kay summarised his analysis on the topic of fiduciary duty and his interpretation of its current definition in the following terms:

Case law identifies a fiduciary as ‘someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence’.⁴⁴

However, he believed that a greater focus needed to be placed on the principles of loyalty and prudence, rather than the technical legal interpretation as it stood:

Loyalty means putting the client’s interest first, and prudence, which relates to both clients’ interest and conflict, is essentially about doing what you would do yourself if you were in the position of the client.⁴⁵

29. Professor Kay went on to outline his expectations for a new definition. He told us that he had two minimum expectations. Firstly:

That anyone who is engaged, either in advice or in discretionary activity of some kind, accepts the obligation to put the client’s interests first, ahead of his or her own.

The second is that conflicts of interest should be avoided, and should be disclosed where they are not avoided. There should be a requirement not to profit as a result of the existence of the conflict of interest. I think that these are the minimum standards, and in my view, I do not want to distinguish between wholesale and retail markets in the application of these.⁴⁶

With respect to fiduciary duty, Professor Kay recommended that the Law Commission should “review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers”.⁴⁷

30. The Government accepted this recommendation and the Law Commission has taken on the project:

In broad terms [the Government] ask us to set out what the current law requires pension trustees, investment managers and other financial intermediaries to consider in deciding an investment strategy. In particular, do fiduciary duties apply to all those in the investment chain? And how far must fiduciaries focus exclusively on maximising financial return, to the exclusion of other factors?

44 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 9.3

45 Q 57

46 Q 56

47 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 69, rec 9

We are not asked to look at the law in isolation. Instead, the project will consult stakeholders about their understating of the law and how it impacts on them.

Next we will evaluate the law according to a variety of criteria. In particular, is the law sufficiently certain? And does it do enough to encourage long-term investment strategies? If we think changes are needed we will make broad recommendations for reform. However, we have not been asked to draft legislation.⁴⁸

31. Christine Berry, Head of Policy and Research at FairPensions (now ShareAction), was “supportive” of the Law Commission’s work to clarify the definition, but she stressed that “we should not assume that at the end of the process it will be sufficient just for the Law Commission to pronounce that “this is what we think the law is”, and it will change behaviour”.⁴⁹

32. The Law Commission has announced that it “will publish a consultation paper by October 2013”.⁵⁰ After analysing the responses, it plans to “publish a final report with our recommendations by June 2014”.⁵¹ We were concerned that the timetable lacked any urgency.

33. Tomorrow’s Company told us that “fiduciary duty is not well understood by pension fund trustees and needs to be appropriately and more widely interpreted”.⁵² The Investment Management Association told us that “asking the Law Commission to undertake such a review will mean that it will be subject to an open and transparent consultation process”.⁵³ However, it went on to warn us that “fiduciary principles at law may not be capable of exact definition”.⁵⁴ BlackRock, on the other hand, rejected Professor Kay’s findings and told us that the rules around fiduciary duty were “sufficiently well understood under English law”:

We believe that UK asset managers understand their obligations, which include contractual (setting the scope of who a manager’s customer is, the guidelines to be applied, etc.) and regulatory (both at an EU or UK level) duties. These are high standards already.⁵⁵

34. We also heard evidence that the lack of clarification is having a material impact on the stewardship of firms and the investment behaviour (in terms of short or long-term outlook) of fund managers. FairPensions (now ShareAction) argued that this lack of clarity resulted in investment managers being discouraged from taking a long-term or progressive

48 The Law Commission, *Fiduciary Duties of investment intermediaries: Initial questions*, March 2013, paras 1.5–1.6 & 1.10–1.12

49 Q 161

50 Law Commission website, *Fiduciary Duties of Investment Intermediaries* [accessed 21 June 2013]

51 Law Commission website, *Fiduciary Duties of Investment Intermediaries* [accessed 21 June 2013]

52 Ev 145

53 Ev 150

54 Ev 158

55 Ev 130

approach to the companies in which they invest and that this needed to change as a matter of urgency.⁵⁶

35. When we questioned the Department, it told us that:

The project is additional to the agreed Law Commission work programme. BIS and the Department for Work and Pensions will therefore jointly provide to the Law Commission funds sufficient to meet the costs associated with the project, up to but not exceeding £90,000 for the financial year 2013–14 and £50,000 for the financial year 2014–15. The contribution will be divided equally between BIS and DWP, and will be payable quarterly in arrears on the Law Commission’s invoice.⁵⁷

It went on to assure us that the Departments’ expectation was that “the total costs for the current financial year will be in the region of £75,000”.⁵⁸ The Secretary of State confirmed that he had not attached any timescale to the Law Commission’s work:

We have not set a deadline, but I have specifically asked that they deal with this expeditiously and get a move on, precisely because of the suspicion that I had already heard, which you have expressed very well. We do want some answers quickly. The problem about taking shortcuts on complex, legal questions is that the outcome is then disputed.⁵⁹

However, he agreed that it was “frustrating” and “would much rather we had some quick results with some of these things”.⁶⁰

36. The Law Commission is currently consulting on the legal definition of fiduciary duty and will not report back until June 2014. We believe that this is too slow. We recommend that the Government liaises with the Law Commission to bring forward the timing of this project. The Government is paying up to £140,000 for this project and we expect it to push for the highest value for the taxpayer’s money. The Law Commission will launch a three month consultation in October 2013. We suggest that it gives this issue the appropriate priority and publishes its final definition in the first quarter of 2014.

Appointment of executives

37. Professor Kay recommended that:

Companies should consult their major long-term investors over major board appointments.⁶¹

56 Ex 109

57 Ev 170

58 Ev 170

59 Q 348

60 Q 348

61 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 63, rec 5

In making this recommendation, Professor Kay said that it was targeted at “major board appointments” and that for smaller companies “it would probably be primarily about the chairman and chief executive”.⁶²

He also clarified that he would apply this recommendation to the “six to 10 large asset managers who are now speaking for a very large proportion of UK equities”.⁶³ The Government accepted this recommendation:

The Government agrees with the Kay Report that efforts by companies to consult their shareholders in advance of making major appointments to the board is consistent with developing long-term trust-based relationships that support engagement in pursuit of sustainable value creation.⁶⁴

It went on to connect this recommendation to the Investor’s Forum:

The establishment of an investor forum, as suggested by Professor Kay, may provide a means for such consultation to take place, but it need not be the only means. Many companies already consult shareholders on board appointments in the context of wider engagement activity and this is to be welcomed.⁶⁵

38. Several witnesses indicated that this recommendation was unnecessary as the practice already took place. Aberdeen Asset Management plc told us that it already held “regular meetings with management and board members to discuss strategic, operational, risk and governance matters”.⁶⁶ As an investor, it aimed to visit companies at least once a year “but, in practice, it is often at least twice annually”.⁶⁷ The Investment Management Association told us that many asset managers were already specifically consulted on major board appointments:

This already happens and investors welcome it particularly when a company is considering changes at a time when the company concerned is in difficulty or to key roles such as chairman or chief executive.⁶⁸

39. Other asset managers, however, corroborated Professor Kay’s view that “asset managers would say that they did not really have the expertise to do this”.⁶⁹ Neil Woodford confirmed that he did not feel that the role of the fund manager was “to tell companies how to run their businesses”.⁷⁰ He took the argument a stage further by telling us that Professor

62 Q 38

63 Q 37

64 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.28

65 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.28

66 Ev 169

67 Ev 169

68 Ev 148

69 Q 40

70 Q 219

Kay's recommendation would actually damage performance and that "boards would become dysfunctional if all their fund managers were trying to chip in and tell them how to run their business".⁷¹ Lord Myners concurred. He questioned why asset managers should be consulted on such decisions, given that they had no business experience:

I would like to question whether the idea that fund managers should talk to companies about strategy, organisation and incentive would actually be testing them on issues where they have a competence. Most fund managers have not done anything other than work in the City, in fund management. They have never run a business.⁷²

Professor Kay acknowledged this concern but expressed his hope that, over time, asset managers would gain the expertise to carry out this objective.⁷³

40. Other witnesses told us that, qualified or not, fund managers would not want to be involved in these decisions because it would mean becoming an 'insider' which could create a conflict of interest. This would restrict such a manager from trading his or her shares. To us, this is an illustration of the dysfunctional relationship created by the role of asset managers. The fact that managers represent the owners of shares but do not want to take responsibility for the ownership of the companies summarises the heart of the issue. The Association of General Counsel and Company Secretaries of the FTSE 100 summarised the problem:

Information about individual appointments, particularly for senior or executive directors, may constitute price-sensitive information about a company. The disclosure (or delay in disclosure) and the dissemination of such information is therefore subject to significant regulatory constraints. If the information is considered to be inside information, the investor would need to be wall crossed prior to any discussions. This may be problematic as, in our experience; institutional investors are unlikely to agree to this if discussions are continuing for any period of weeks, as they would be prevented from dealing for a prolonged period of time.⁷⁴

41. Lord Myners characterised institutional investors as saying "we don't like being made insiders" because "we don't like to give up our right to deal".⁷⁵ Lord Myners expressed dissatisfaction that this was the case but told us that as it stands, Professor Kay's recommendation was simply not practical:

The right approach [...] is to say "we relish the opportunity of being insiders. We would like to be insiders. If that means we can't deal for a month or so, that's neither here nor there if we get the chance to have a voice".⁷⁶

71 Q 219

72 Q 129

73 Q 40

74 Ev 117

75 Q 107

76 Q 107

42. Albion Ventures took a different view. It told us that consultation of major shareholders was a start, but that Professor Kay had not gone far enough. It recommended that “long-term substantial shareholders should have representation on the boards of companies in which they invest”.⁷⁷ It argued that this would “allow longstanding investors to have personal, reciprocal and trust-based relationships with the company management”.⁷⁸ We asked Harlan Zimmerman, Senior Partner at Cevian Capital, how the current appointment system could be improved and how external forces should influence the decision. He told us that it was not necessary for shareholders to be represented on the boards of companies because the non-executive directors were supposed to be fulfilling that role. However, he went on to explain that the role of non-executive directors had been ignored and described the fact that this was overlooked by Professor Kay as being “the single biggest problem” with the Review:

Fidelity, even with the best will in the world, cannot look after the day-to-day operations of thousands of companies, so we have non-executive directors who are there, who are supposed to be doing that job for us.

Now, the companies will say they do consult with their major shareholders on non-execs, and the asset managers will say that they do consult as well, but the reality is that when that happens it is a very superficial consultation in most cases. It very often takes the form of a Sunday night call before an announcement on Monday. If you look at one single damning fact, director elections here in the UK for non-executives are a rubber-stamping exercise.⁷⁹

43. Professor Kay has provided a clear recommendation, proposing that companies consult with major investors over all board appointments and the Government has agreed to implement this. We therefore recommend that the Government publishes a timetable for the implementation of this policy, clarifies which investors companies are to consult with and outlines how it intends to combat the issues surrounding insider trading and confidentiality which inevitably accompany such board appointments. Alongside this, the Government should undertake an impact assessment, particularly looking at the possible increase of bureaucratic burdens on small businesses and, if necessary, introduce an opt-out clause for them.

Remuneration of executives

44. Professor Kay recommended:

Companies should structure directors’ remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives

77 Ev 90

78 Ev 90

79 Q 201

should be provided only in the form of company shares to be held at least until after the executive has retired from the business.⁸⁰

When he spoke to us, he outlined his vision for the principles underlying this recommendation:

What I want to see is people running large British companies whose primary motivation is that they want to build great British businesses.⁸¹

45. The Government accepted the principle behind the recommendation but not any specific role in its implementation. It did, however, refer to work it was already undertaking to reform the governance processes behind executive pay:

The Government agrees that the structure of remuneration should be determined by individual companies in consultation with their shareholders and that agreeing and sharing good practice is the appropriate way to promote change in this area. The Government does not believe there is a case for blanket regulation of the structure of company directors' remuneration and believes that companies and their shareholders need flexibility to negotiate outcomes that work for them. The Government's comprehensive reforms to the governance framework for directors' remuneration will help to support change in this area.⁸²

46. The Government was also positive in its support of Professor Kay's ideas for performance incentives to come in the form of shares which would be held until the executive had left. However it stopped short of implementing this recommendation, instead stating that this could be achieved through "good practice" rather than through state intervention:

The Government believes that Professor Kay's prescription for long-term incentives—that these should be in the form of shares to be held beyond the individuals' departure from the company—is an idea which companies should actively consider.⁸³

47. We received a significant body of evidence on this recommendation. The National Association of Pension Funds Limited agreed with Professor Kay that "the best form of alignment between executives and shareholders is the ownership of shares over the long-term".⁸⁴ Lord Myners agreed with the recommendation in principle, but cautioned us that it may not work in practice:

80 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 79, rec 15

81 Q 72

82 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.64

83 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.62

84 Ev 125

Conceptually, it is rather attractive, but it is wholly unenforceable. Logically, you would sell your interests through derivatives. You might leave the company in order to be able to sell.⁸⁵

He concluded that “a director can actually have too much of their wealth invested in the company. They become too obsessed with the share price”.⁸⁶ The Investment Management Association suggested a compromise to encourage positive behaviour through incentives. While they agreed with Lord Myners that requiring executives to hold the shares until after they had retired “could result in them leaving a company when they consider it the best time to realise those shares”,⁸⁷ they went on to assert that:

Investors want companies to have remuneration policies that are aligned with their interests such that they promote long-term value creation, take account of the fact that effecting change to a company’s strategy takes time, and mirror a company’s development cycle.⁸⁸

The IMA recommended that the current system used by many companies could be tweaked without the need for a change in regulation or austere shareholding requirements:

A suitable compromise between career shares and the current standard practise for three year Long-term Incentive Plans (LTIPs) would be five year LTIPs. There need not necessarily be a five year vesting period but at a minimum, there should be a period of at least five years between the date of grant of the award and any sale of shares.⁸⁹

48. Several of our witnesses agreed that, while shares were an effective way to connect executive pay to company performance, Professor Kay’s recommendation was something of a blunt tool. For example the Chartered Institute of Personnel and Development (CIPD) told us that the “focus on financial gain to the exclusion of other considerations has played a large part in distorting views of businesses’ purpose” and that performance should go “beyond the purely financial and how much profit is being generated”:

As well as generating profit, business leaders must show awareness of, and commitment to, longer-term stewardship responsibilities, as well as the leadership qualities required to take their workforce with them and drive sustained high performance. The measures used to determine pay of executives and the different reward components should be visible and open to external scrutiny.⁹⁰

49. Other experts agreed with the Government that there was no case for blanket regulation in this area. The Association of General Counsel and Company Secretaries of

85 Q 124

86 Q 124

87 Ev 152

88 Ev 151

89 Ev 152

90 Ev 137

the FTSE 100 stressed that any change to the executive pay regime had to preserve an element of flexibility. It withheld support for Professor Kay's recommendation and concluded that there could never be a "one size fits all" policy to achieve this.⁹¹ It wrote to us with four arguments against the compulsory implementation of Professor Kay's recommendation:

1. Such a policy is likely to make it considerably harder to attract good candidates. This is likely to be a particular issue for the many London-listed companies which have some or all of their operations and/or directors located outside the UK.
2. Directors have come to rely on the performance related pay and deferral for the length of time envisaged by the Recommendation may be impractical.
3. Such a policy may simply shift the emphasis from performance related pay to basic pay which could possibly mean that there is less incentive for management to pursue performance enhancing strategies.
4. Such a policy [may] encourage the early resignation of successful executives (to trigger release of their long-term incentive gains), leading to an increased 'churn' of executives, and thereby reducing long-term strategic focus.⁹²

50. Standard Chartered Bank also argued that Professor Kay's recommendation would distort the market and damage the leadership of British firms:

Making executives retain shares could in effect encourage the wrong behaviours like incentivising them to leave the organisation to realise value from their locked in holdings. [...] Executives nearing retirement could be tempted to take actions designed to drive up the share price in the short-term.⁹³

51. By contrast, the UK Sustainable Investment and Finance Association expressed frustration that the Government had not fully accepted this recommendation and that the Government had "yet to facilitate a deep and constructive debate specifically on incentives and pay within the investment chain".⁹⁴ We asked Professor Kay to comment on the Government response to this recommendation. He too expressed regret that his recommendation had apparently been sidestepped, and asserted that, because "people frequently do specific things they are incentivised to do", the current system of executive pay was incentivising the wrong behaviour and needed to change.⁹⁵ He believed that there was an argument for his recommendation to have been made compulsory.⁹⁶

91 Ev 118

92 Ev 118–119

93 Ev 89

94 Ev 142

95 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 11.5

96 Q 73

52. The Government has accepted the principles underlying Professor Kay's recommendation on the remuneration of executives. We are therefore disappointed that it has failed to take the action to see it put into practice or responsibility for its implementation. We are not persuaded by the Government's view that businesses will see the benefit of this recommendation and will adopt this measure voluntarily.

53. *We support the recommendation that company directors should be tied into the long-term performance of their companies through time-appropriate shares. Since the Government has accepted Professor Kay's analysis and agreed with his findings, it should reconsider its response and take an active approach to its implementation. In particular, we recommend that the Government outlines how it intends to combat the issue of directors using options and derivatives to avoid these rules. Alongside this the Government should outline how it will ensure that departing directors will not be perversely incentivised to artificially inflate the share price immediately prior to their retirement or retire early to realise the locked-in value of their shares.*

Incentivising fund managers

54. Professor Kay recommended:

Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund.⁹⁷

55. The Government accepted the principles underlying this recommendation:

Professor Kay's stated intention to shift the culture of asset manager pay through the development of industry good practice, rather than by imposing pay structures in regulation. Recommendation 16 is therefore reflected in the Kay Good Practice Statement for Asset Managers. The Government will encourage asset managers to adopt such models by promoting consideration of the Kay Good Practice Statement for Asset Managers.⁹⁸

56. With regard to current remuneration practices, Russell Investments agreed with Professor Kay's analysis. It stated that a short-term focus was "encouraged by the business models of asset managers who are generally incentivised to maximise the volume of assets they gather rather than focus on good, long-term outcomes for their investors".⁹⁹ It went on to tell us that owners tended to follow fashionable managers:

97 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 80, rec 16

98 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.68

99 Ev 97

A successful manager need only produce short bursts of good performance to attract assets and hence profits and then seek to avoid the sort of underperformance that would cause those assets to be lost.¹⁰⁰

57. The Investment Management Association took this further and told us that owners were not overly concerned with the remuneration of the managers they instructed because they were paid by the asset management firm, not by the client directly:

While the level of fees has an impact on performance, individuals are paid by the firm, not by the client, so that decisions about an individual's remuneration do not affect the cost to clients.¹⁰¹

It went on to warn us that too strict aligning of the performance of a manager's fund and remuneration "could encourage a portfolio manager to leave at a time when their particular fund is performing well for clients".¹⁰²

58. BlackRock was keen to highlight the fact that the current system of remuneration of asset managers often had performance incorporated. It told us that, for its managers, "compensation reflects investment performance over the short, medium and long-term and the success of the business or product area".¹⁰³ It went on to explain that "a limited number of investment professionals have a portion of their annual discretionary awarded as deferred cash that notionally tracks investment in selected products managed by the employee",¹⁰⁴ but it warned us that this could not be rolled out more widely because of global regulation:

Such co-investment is not always possible. For example, as a result of the significant compliance burden with respect to the US Foreign Account Tax Compliance Act (FATCA), a US national is generally precluded from investing in a UK fund.¹⁰⁵

Neil Woodford, Head of UK Equities in Invesco Perpetual, believed that incentive structures were "really important around performance measurement and the hiring and firing of fund managers".¹⁰⁶ It recommended that changing those structures to a longer term perspective would be "a very important step in encouraging longer term behaviour and more engagement".¹⁰⁷ Chris Hitchen, Chief Executive of RailPen, agreed. He drew on his experience in the pension industry to elaborate on how the definition of success for fund managers needed to be changed:

100 Ev 97

101 Ev 152

102 Ev 152

103 Ev 133

104 Ev 133

105 Ev 133

106 Q 249

107 Q 249

It would probably have to be more around, “Have you contributed real value to my pension schemes’ assets over many years?” rather than, “Have you beaten the market last quarter?”¹⁰⁸

59. Other witnesses brought up the issue of ‘tracking-error’. Dominic Rossi, Global Chief Investment Officer at Fidelity Worldwide, explained that “tracking error is a statistically based measure of the likely deviation of returns of the portfolio versus the specified benchmark”.¹⁰⁹ It is often used as a measure of success when investors chose which fund managers to trust their capital with. While it may be appealing to have some measureable way of tracking performance, Lord Myners explained that this was a somewhat blunt tool:

Most fund managers regard themselves as in some ways enslaved by [tracking error], and would say in their true hearts that they would rather be able to run a portfolio with a higher tracking error. [...] Kay does not get to grips with these things.¹¹⁰

Other witnesses told us that tracking error was partially responsible for the over diversification of portfolios. Harlan Zimmerman, Senior Partner at Cevian Capital, summarised this argument:

It forces the portfolios to be much, much greater than they need to be. [...] Many problems of the investment industry are encapsulated by the very phrase “tracking error”—it is the word “error.” [...] That is a root of many problems, as I say, because it causes over-diversification of portfolios and an inability to pay for resources necessary to work with them in a good way.¹¹¹

Lord Myners asserted that the industry was aware that current measures of performance simply did not give fund managers enough confidence to invest over the long-term for fear of appearing deficient compared to the short-term benchmark:

Most asset managers would welcome anything that encouraged them to believe that their clients would support them over a longer term; that their clients were less focussed on the very short-term; and that their clients were less focussed on how they did against the index.¹¹²

60. It was generally agreed that even when fund manager remuneration was linked to some measure of performance, the measure of performance was often short-term and set against inappropriate benchmarks. FairPensions (now ShareAction) wrote to us to summarise its research and proposed eight steps to align the incentives of investors and fund managers to the more long-term:

- Fund manager performance should be reviewed over longer time horizons than the typical quarterly cycle.

108 Q 249

109 Q 192

110 Q 127

111 Q 192

112 Q 127

- Excessive reliance on measuring performance relative to a market index should be reduced.
- Pension funds should have voting and engagement policies that should be integrated into the investment process.
- Shareowner activism should be given more weight in the selection and retention of fund managers and other matters.
- All advisors to institutional investors should have a duty to proactively raise ESG issues and encourage adherence to the Stewardship Code.
- Fund management contracts and fund managers' performance should include an evaluation of long-term ability to beat benchmarks.
- Investment consultants' fee structures should not reward them for moving clients between fund managers.
- Within companies the implementation of strong cultural norms should be supported by independent whistleblowing mechanisms, overseen by professional bodies who offer the whistleblower appropriate protection.¹¹³

Catherine Howarth, The Chief Executive Officer for FairPensions (now ShareAction) did temper this evidence with a call for simplicity:

There are huge risks in trying to be too clever with the remuneration of fund managers. [...] There is much more performance-related pay now in fund management. That brings a host of risks because, depending on the time frame involved, it will exacerbate the existing compulsion towards short-term trading in the emphasis of fund managers over long-term stewardship orientation.¹¹⁴

61. The Government has promised to “encourage asset managers to adopt such models [incorporating performance measures into the remuneration of fund managers] by promoting consideration of the Kay Good Practice Statement for Asset Managers”.¹¹⁵ However, it is not clear whether the Government is taking an active or passive role in this change.

62. The incentives driving the actions of fund managers are one of the most important factors within the investment chain. Professor Kay made a specific recommendation on this but the Government has shied away from accepting it, citing an unwillingness to prescribe pay structures. While this may be understandable, it is clear that the Government must be involved; at the very least encouraging a cultural shift away from short-term to long-term performance-based pay.

113 Ev 105–106 [extracts]

114 Q 142

115 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.68

63. *We recommend that the Government takes a harder line when framing the culture in which fund managers work by highlighting best practice where it sees it. We further recommend that it should work towards the goal that fund manager performance be reviewed over longer time horizons than the typical quarterly cycle.*

64. *One way that the Government can help effect a culture change in the incentives driving fund-manager behaviour is to develop and publish a set of long-term measures of success alongside options for sanctions for demonstrable failure. We recommend that it does so, and then annually publishes a list of those firms that have fully adopted such measures. This would provide a different measure of success to the very short-term ones which are currently available.*

Quarterly Reporting

65. In respect to company reporting, Professor Kay made two recommendations:

- i. Companies should seek to disengage from the process of managing short-term earnings expectations and announcements;¹¹⁶ and
- ii. Mandatory IMS (quarterly reporting) obligations should be removed.¹¹⁷

The Government accepted both recommendations and went on to clarify that, since the Kay Review had been commissioned, the European Commission had brought forward proposals to amend the Transparency Directive. Implementation of the recommendation removing quarterly reporting obligations would, therefore, be dependent of the successful passing of the amendment and upon negotiation with the EU:

The Government has already made clear its strong support for the [European] Commission's proposal [to amend the EU Transparency Directive] and will therefore take forward work to deliver this recommendation in the context of ongoing negotiations with the Commission and EU Member States.¹¹⁸

The initial assurances that the Government had apparently fully backed Professor Kay on this recommendation were somewhat dampened, however, when we read further down the government response. In that response, the Government went on to say that once the EU directive had been amended, any change would then depend on further consultation:

UK implementation of the proposed changes would fall to the FCA and be subject to consultation and cost-benefit analysis.¹¹⁹

66. Professor Kay told us that he had clarified his analysis behind the recommendation. He began by asserting that the idea that more information was always better was “not true”.¹²⁰

116 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 64, rec 6

117 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 74, rec 11

118 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.52

119 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.52

He found that “companies produce steady streams of reported quarterly earnings” which served to encourage those involved to think only from one quarter to another which potentially damaged the long-term performance of firms.¹²¹ He concluded that this should be replaced by “more qualitative relationships between the company and the asset manager”.¹²² Aviva plc took a similar view:

Such short-term reporting cycles contribute to short-term thinking and can discourage investment for the long-term, given the impact that could have on short-term performance.¹²³

67. Other experts agreed that the process of producing short-term (quarterly) reports had had a behavioural effect on the managers and investors both producing and reading them. BlackRock explained that:

Quarterly reporting does potentially place undue focus on short-term developments that may have little material impact over the longer term. Too frequent disclosure can make the market lose sight of the longer term objectives and judge the company on its short-term achievements. This, in turn, might make it more difficult for boards to focus on the long-term development of their business.¹²⁴

The Chartered Institute of Personnel and Development also believed that reporting on a quarterly basis may have acted as “a contributory factor to a short-term outlook on company performance”.¹²⁵

68. By contrast, Albion Ventures did not believe that quarterly reporting was at the heart of the problem:

While we accept that some quarterly reporting will contribute to short-sighted business practices when the content has been “managed” to appear in the most positive light, we do not believe that the procedure should be removed altogether.¹²⁶

It went on to explain that it was not the frequency of such reports that was the problem, but the content and that current reporting practices did not focus on the correct information. Specifically, companies should steer away from “marketing speak” and move towards “something much more balanced, objective and long-term minded”.¹²⁷ Dr Woolley, Head of the Paul Woolley Centre for the Study of Capital Market Dysfunctionality, also argued that there was “no merit” in reducing the flow of information and told us that “the quarterly reporting of pension fund returns should still go on”.¹²⁸

120 Q 65

121 Q 66

122 Q 66

123 Ev 104

124 Ev 130

125 Ev 139

126 Ev 104

127 Ev 90

128 Q 158

69. Finally, we were warned by the Association of General Counsel and Company Secretaries of the FTSE 100 that any changes in the UK (or Europe for that matter) will have a diminished effect because of the global nature of reporting standards:

For UK companies with international businesses, notably those with operations or listings in the US, there may still be a legal or regulatory requirement to report more frequently and/or in a way that engenders a short-term view.¹²⁹

70. We support Professor Kay’s recommendation that the requirement for quarterly reporting should be removed and recommend that the Government now outlines a clear timetable to implement this recommendation including what alternative strategies would be followed in the absence of any change in EU law.

71. We recommend that the Government sets out details of progress in negotiations with other international accounting standard bodies (such as the U.S. Securities and Exchange Commission) on the requirement for quarterly reporting to ensure that any changes made to the domestic or EU-wide accounting practices are accepted on a global level.

Narrative Reporting

72. Professor Kay recommended:

High quality, succinct narrative reporting should be strongly encouraged.¹³⁰

The Government accepted this recommendation:

The Government supports this recommendation. We are already focused on this policy objective, which was the subject of a Coalition Government commitment, and have carried out two consultation exercises in the past two years.¹³¹

The Government has stated that it will introduce regulations to “bring about the changes to the structure and format of reporting” and the intention is for these to come into effect by October 2013.¹³² The Government, in its response to the Review, went on to say that it would be “working closely with the Financial Reporting Council (FRC) as they develop the guidance on the new provisions”.¹³³

73. Professor Kay concluded that good reporting went against the instinct of most company directors:

129 Ev 118

130 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 74, rec 12

131 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.53

132 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.56

133 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.56

An annual report is not easy to read because its format is driven by regulatory requirements and those who write it often have little inclination or incentive to communicate information beyond that required to fulfil that obligation.¹³⁴

Daniel Godfrey, Chief Executive of the Investment Management Association, agreed:

The last place you would go if you wanted to find out about the company now, almost, is the report and accounts.¹³⁵

74. Lord Myners agreed, but took the issue further and told us that irrelevant information or an absence of information was less serious than misleading data. In particular, he agreed with Professor Kay's recommendation for narrative reporting:

In numbers, you can fudge all sorts of things. You can put apples with pears and call them lemons, and your auditors may well allow you to do that. It is when you come to express in words what is happening in the company that the directors get quite exercised about their legal liability if their statements are not full, clear and unlikely to be ambiguous.¹³⁶

75. Tomorrow's Company warned that, while they "strongly welcome" the recommendation and had "long argued" for such a change in regulation there was a "danger of overload".¹³⁷ It told us that this was because there were so many regulatory and market initiatives, changes and consultations throughout the world which focused on different aspects of reporting:

The proposals for narrative reporting need to be framed in a context which reinforces this coherence of approach by recognising the systemic nature of the corporate reporting system and the place of the specific reform in that wider context.¹³⁸

76. The Association of General Counsel and Company Secretaries agreed, stating that "it will be important to ensure that there is a 'joined-up' approach between all legislative and regulatory bodies".¹³⁹ It took this further and told us that domestic reporting standards would be ultimately ineffective when held against the reporting requirements of other countries'. It concluded that "any streamlining of the UK position would be undermined by US regulation which, generally, requires more detailed reporting".¹⁴⁰

77. Lord Myners, however, did not consider narrative reporting to be an onerous burden:

134 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 10.11

135 Q 301

136 Q 113

137 Ev 145

138 Ev 145

139 Ev 118

140 Ev 118

What would you want to know about the company in that 10-minute meeting every quarter? Write that down, and then compare it with what you tell your shareholders, and try to reconcile why there is such a huge difference between the two.¹⁴¹

78. We recommend that the Government sets out how it will ensure that enhanced narrative reporting will remain consistent with, and accepted by, overseas regulators, for example the US Securities and Exchange Commission.

79. When the proposed changes are made to the structure and format of reporting, the Government (through the Financial Reporting Council) will need to ensure that any accompanying guidance on the new provisions included clear minimum standards to ensure comparability. The Government must not shy away from strict enforcement of these standards. The scrutiny and consistency of narrative reports may be harder than that of reports containing only information about pounds and pence, but the Government must ensure high standards are maintained. We therefore recommend that the Government outlines how it proposes to implement auditing and monitoring of narrative reports. Ongoing shareholder scrutiny and transparency must be at the heart of this. These processes must be in place before the proposed changes come into effect.

5 More work to be done?

80. We now consider some of the less-specific ‘recommendations’ and underlying principles of the Kay Review. In particular, the Stewardship Code, resourcing stewardship, using a Financial Transaction Tax to incentivise behaviour and the role of owners in the process of mergers and acquisitions.

The Stewardship Code: Content

Box 1: The UK Stewardship Code

The UK Stewardship Code aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities. The Code sets out good practice on engagement with investee companies to which the Financial Reporting Council believes institutional investors should aspire and operates on a ‘comply or explain’ basis. The Financial Standards Authority requires UK authorised asset managers to report on whether or not they apply the Code.

First published in July 2010, the Code was revised in September 2012; the Financial Reporting Council encouraged all signatories to review their policy statements once the Code came in to effect from 1 October 2012.¹⁴²

81. In its current form, the Stewardship Code is voluntary. It embodies seven principles for institutional investors to:

1. Publicly disclose their policy on how they will discharge their stewardship responsibilities.
2. Have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed.
3. Monitor their investee companies.
4. Establish clear guidelines on when and how they will escalate their stewardship activities.
5. Be willing to act collectively with other investors where appropriate.
6. Have a clear policy on voting and disclosure of voting activity.
7. Report periodically on their stewardship and voting activities.¹⁴³

82. In his review, Professor Kay recommended that the Code be “developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of

¹⁴² Financial Reporting Council website, *UK Stewardship Code* [accessed 21 June 2013]

¹⁴³ Financial Reporting Council, *UK Stewardship Code*, September 2012, page 5

corporate governance”.¹⁴⁴ The Government noted the recommendation and highlighted the fact that the Financial Reporting Council (FRC) reviewed the implementation and impacts of its Codes, and would produce its next report on developments in Corporate Governance and Stewardship in December 2013.¹⁴⁵ The Government concluded that:

In light of this and future exercises it will consider whether further changes to the Stewardship Code may be desirable in due course to reflect Professor Kay’s recommendation.¹⁴⁶

83. The Chartered Institute of Personnel and Development did not believe that the Code required reform as it already focussed on corporate governance:

The revised UK Stewardship Code of September 2012 already includes strategy, corporate governance and culture within its definition of ‘stewardship activities’, on which institutional investors are encouraged to publicly disclose their activity with the aim of protecting value for their clients.

It is also recommended that investors should consider intervening when they have concerns about the company’s strategy, governance and approach to risks, including those that are social or environmental.¹⁴⁷

Steve Waygood, Chief Responsible Investment Officer at Aviva Investors, thought that the current Code, while fit for purpose, could be improved:

If I was rewriting the Stewardship Code, I would add a provision in there encouraging those people who sign up to the Stewardship Code to examine how they use their research commission to promote and finance stewardship.¹⁴⁸

84. FairPensions (now ShareAction) proposed four specific improvements that should be included in an improved Code:

- Articulate more explicitly that engagement can and should extend beyond immediate financial matters and encompass drivers of a company’s long-term fundamental value, including environmental, social and governance (ESG) factors.
- Address more explicitly the role of institutional investors, particularly ‘universal owners’ such as pension funds with holdings across the economy, in nurturing the wider economy and attending to potential systemic risks, rather than only engaging with risks to individual companies in their portfolio.

144 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 45, rec 1

145 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.5

146 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.5

147 Ev 138

148 Q 250

- Be stronger and clearer in respect of conflicts of interest. [...] The recent amendments to the Code [...] do not seek to ensure that signatories explain how key conflicts of interest are managed in practice.
- Articulate a clearer definition of ‘stewardship’. [...] The Code still does not define the term ‘stewardship’ as such. In our experience, there is still confusion over what is being ‘stewarded’ (companies, savers’ assets, or the economy and environment on which financial returns depend) and to whom stewardship obligations are owed (companies or savers).¹⁴⁹

Blackrock told us it defined the term ‘stewardship’ as “protecting and enhancing the value of the assets entrusted to us by our clients. As shareholders, our stewardship responsibility is to our clients”.¹⁵⁰ However, it warned us that good stewardship would not necessarily lead to more engagement with firms because asset managers must put their client first (rather than the long-term health of the companies that they hold):

Sometimes fulfilling our stewardship responsibilities to clients will involve engagement with companies; other times it will necessitate selling or reducing a shareholding if we cannot protect our clients’ interests through engagement, which should not be seen as a derogation of our duty, but a fulfilment of it.¹⁵¹

85. In its current form, the Stewardship Code contains seven voluntary principles which represent the minimum benchmark for the relationship between owners and investment managers. Professor Kay recommended that the Code should be developed to take account of strategic issues as well as those around corporate governance. We recommend that this be implemented through a formal consultation by the Financial Reporting Council. It is essential that the Code is accepted by all players of the equity market, therefore all such participants must have a say in its development. Having considered the evidence and suggestions from many players in the market, we specifically recommend that the Code be enhanced:

- ***To allow investment managers to focus on strategic issues facing companies within their policies on how they discharge their stewardship responsibilities (rather than the current focus on profit, which is inherently short-term).***
- ***To include the principle that engagement and corporate governance should extend beyond financial affairs and encompass more long-term value adding activities such as environmental, social and governance factors.***
- ***To include the provision that institutional investors and significant owners should be members of at least one Investor’s Forum.***

149 Ev 111–112

150 Ev 129

151 Ev 129

- *Related to the previous point, to include the role of institutional investors to engage in potential systemic risks to the UK equity market rather than only engaging with risks to individual companies in their portfolio.*
- *To redefine a clearer explanation of conflicts of interest and in particular for asset management firms to publish how key conflicts of interest are managed in practice.*
- *To provide one clear and authoritative definition of the term ‘stewardship’.*

The Stewardship Code: Sign-up

86. In its current form, 203 Asset Managers, 67 Asset Owners and 14 Service Providers have signed up to the Stewardship Code (although one organisation is listed as both an asset manager and a service provider).¹⁵² The Financial Reporting Council (FRC), which administers the Code, gave us the latest figures in terms of how much of the UK equity market is covered by the Code, referring to an IMA survey:

The IMA reported that the 103 respondents to this year’s survey included 73 managers who are responsible for £702 Billion of UK equities representing 36% of the UK market.¹⁵³

It went on to tell us, however, that because “not all signatories responded to the IMA survey”, it was “reasonable to say the overall total is slightly higher than the IMA’s figure”.¹⁵⁴

87. Although the rate of sign-up to the Code may have improved, the overall number of signatories remains low, particularly among owners (for example pension fund trustees). Penny Shepherd, Chief Executive of UKSIF hoped to see “considerably more asset owners signed up to the Stewardship Code”.¹⁵⁵ The National Association of Pension Funds Limited confirmed that its owners (and pension funds in general) had been slow to sign up. It suggested that investment consultants should have responsibility for encouraging more owners to be involved:

As key intermediaries between pension funds and asset managers, investment consultants could do more to encourage the take-up of the Code by explaining its relevance to their pension fund clients. We believe that this could help drive more pension funds to sign up to the Code.¹⁵⁶

Anita Skipper, Corporate Governance Advisor to Aviva Investors agreed. She told us that:

¹⁵² A full list of sign-up to the Stewardship Code may be found on: Financial Reporting Council website, *UK Stewardship Code statements* [accessed 21 June 2013]

¹⁵³ Ev 170

¹⁵⁴ Ev 170

¹⁵⁵ Q 307

¹⁵⁶ Ev 123

A lot of fund managers have already signed up. The disappointing bit is that the owners have not signed up. You want the owners to sign up so that the fund managers actually do the work for them. Fund managers do see the benefit of engagement, which is why [they] spend so much time engaging with companies, but it is very difficult to keep increasing that when nobody is asking you to do it and they do not even care. The focus must be on demand from our perspective.¹⁵⁷

88. When we aired these concerns with the Secretary of State he assured us that “if your hearings [...] elicit quite a lot of evidence that this approach is failing, I would feel obliged to respond to it”.¹⁵⁸ Our inquiry has raised concerns, and we look forward to his response.

89. Progress has been made in terms of the number of asset managers signing up to the Stewardship Code. However, sign-up among owners remains low. We recommend that the Government:

- ***Outlines what it considers a minimum acceptable level of sign up to the Stewardship Code (making provision for the distinction between manager and owner).***
- ***Makes clear that it is government policy to encourage sign-up to the Code and publishes a clear target (and timescale) of success. This timescale should be no longer than two years.***
- ***Outlines clearly what action it will take if this target is not met by the market on a voluntary basis.***

90. Finally, some witnesses pointed out that, at the time of our inquiry, the Parliamentary Contributory Pension Fund (PCPF) was not signed up to the Stewardship Code. Penny Shepherd, Chief Executive of UKSIF, told us that “one area in which this House can act to raise awareness is by acting as an exemplar of good practice”.¹⁵⁹ We are pleased to take this opportunity to formally welcome the fact that the trustees of this fund have made the decision to sign up to the Stewardship Code in the near future. We will continue to monitor this.

157 Q 252

158 Q 354

159 Q 280

The Stewardship Code and Professor Kay's good practice statements

91. As well as analysing the Stewardship Code, Professor Kay also produced three Good Practice Statements. These are outlined in full in the Annex to this report. His recommendation on the matter read:

Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements.¹⁶⁰

The Government responded:

The Government supports this recommendation. The development and promotion of good practice in the investment chain is central to achieving the culture shift that Professor Kay advocates. Professor Kay's suggested Good Practice Statements—aimed at company directors, asset managers and asset holders in turn—provide a starting point from which to achieve this.¹⁶¹

92. In his Review, Professor Kay outlined how he expected the Statements to sit alongside existing regulation:

We do not believe the principles set out in these statements should be translated into specific regulatory requirements. However, we do envisage that Regulators will also endorse these principles, consider to what extent existing regulatory requirements may prevent their adoption, and seek to align existing guidance and codes of practice with them.¹⁶²

He went on to explain that he expected his Good Practice Statements to “complement, and inform further development of the Corporate Governance Code and Stewardship Code”.¹⁶³ Although this approach could add to the regulatory burden, Professor Kay was clear that this was one area where he was happy for the Government to force the market's hand:

If the industries do not develop these kinds of concepts of good practice, I would like Government to intervene and try to do it for them.¹⁶⁴

93. Russell Investments supported Professor Kay's Statements because they were “developed explicitly for the growing and diverse ‘fiduciary management’ segment, which may, in the future, be in control of substantial portions of asset owners' portfolios”.¹⁶⁵ Dr Paul Woolley, Head of the Paul Woolley Centre for the Study of Capital Market

160 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 48, rec 2

161 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.6

162 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 6.22

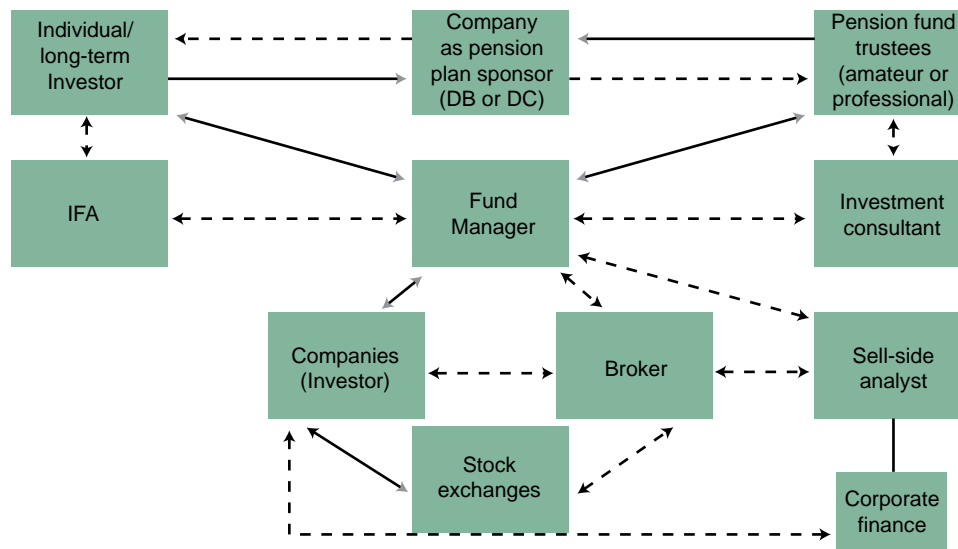
163 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 6.22

164 Q 23

165 Ev 92

Dysfunctionality, also supported the Statements and drew our attention to new recommendations of the Consultative Group on International Economic and Monetary Affairs Incorporated (G30) which recently made similar recommendations.¹⁶⁶ He believed that the industry was on the edge of change and that “there will be a very significant early mover advantage to funds” which adopted such statements first.¹⁶⁷

94. Aviva plc, however, was less supportive of Kay’s Statements. While it welcomed them in principle, it concluded that they “fail to cover all relevant players in the capital market”.¹⁶⁸ They provided the diagram below to demonstrate the complex series of impacts and interactions across the market and outlined which were and which were not covered by the Statements:¹⁶⁹



95. When we asked the Secretary of State how he saw Professor Kay’s Good Practice Statements running alongside existing regulation and voluntary codes, he acknowledged that there was a “mixture of voluntary stewardship codes of practice, on the one hand, and legislation on the other”.¹⁷⁰ However, he set out how Professor Kay’s analysis could be incorporated into the Stewardship Code:

We have just had a wholesale revision, which the FRC oversaw—you know the way the system works. Next year, we have asked them to go back to the stewardship code specifically to take into account the Kay recommendations.¹⁷¹

96. The Secretary of State concluded that reform was “a twin-track approach. There are key areas of corporate behaviour that have to be regulated, and are regulated, but for other

¹⁶⁶ Group of 30, *Long-term finance and Economic Growth*, February 2013

¹⁶⁷ Q 150

¹⁶⁸ Ev 102

¹⁶⁹ This is an updated version of the diagram found in Ev 102. Solid connections represent those which Aviva plc argue are covered by Professor Kay’s Good Practice Statements, dotted connections are those which it argues are not.

¹⁷⁰ Q 349

¹⁷¹ Q 349

areas, where subtle changes are involved, the voluntary approach works well, as it is the best solution and it works”.¹⁷²

97. We support Professor Kay’s Good Practice Statements and agree that the industry, asset holders and company directors should be given the opportunity to formally embrace the principles that are contained within them. However, we are conscious that many individuals and firms are already signed up to the Stewardship Code and we are concerned that yet another voluntary compliance statement will be submerged by a rising tide of self-regulation and codes of best practice. The market requires clarity and certainty and we are concerned about over-burdening it with regulation and codes.

98. Professor Kay’s Good Practice Statements should be the standard level of behaviour for the industry and all players in the UK equity market. We expect the Government, in its response to this Report, to outline its timetable for all companies to sign up to Professor Kay’s Good Practice Statements. If this target is not met, the Government should be prepared to incorporate Professor Kay’s Good Practice Statements into the already established Stewardship Code.

Resourcing stewardship

99. Lord Myners was clear in his mind that stewardship was an under-resourced activity in the investment chain:

There is an inverted pyramid in investment management, in which the least important functions receive the greatest attention and the highest pay, and the most important function receives little attention and, frequently, no pay.¹⁷³

Lord Myners set out where he saw the problem:

The decision on asset allocation for a pension fund—which is about understanding what your optimal level of risk is, creating a risk budget, and then saying that you will invest [...] is taken by trustees who are often unpaid; who are generally not professionals, or particularly economically knowledgeable; and who are led by the nose by consultants.

The most important decisions are taken by the people with least economic incentive and interest in the outcome, little reward, and little experience. On the other hand, the decision that adds no added value at all is hugely rewarded.¹⁷⁴

Harlan Zimmerman, Senior Partner at Cevian Capital, agreed that resourcing the roles of stewardship and governance was a problem across all types of funds. He told us that as a fund manager “you do the minimum that you can to protect your investments” because

172 Q 349

173 Q 117

174 Q 117

“there is a general issue that proper stewardship and engagement is a cost centre”.¹⁷⁵ He went on to explain that managers did the minimum that they needed to maintain appearances as a responsible investor:

You focus only on the greatest transgressions and react in a defensive way, and you do the minimum that society imposes upon you.¹⁷⁶

100. USS Investment Management Limited argued that it was a matter of scale and that stewardship was under-resourced in the relatively smaller UK pension funds when compared to larger funds globally. It told us that this was because funds were “too small to adequately resource their stewardship operations”.¹⁷⁷ It went on to explain that this had contributed to the lengthening of the investment chain and the subsequent distancing of the owner from the company.¹⁷⁸ Russell Investments told us that larger asset owners tended to have stronger governance because they:

- Have better access to expert resource and advice: taking together the number of finance or investment professionals on the trustee body or the investment committee, as well as any full-time in-house investment staff.
- Are more likely to have an investment committee.
- Spend more time in absolute terms on investment issues: trustee boards and their investment committees spend.
- Are more likely to have a more ambitious investment strategy.¹⁷⁹

It argued that consolidation was a practical solution to the problem of smaller funds not having the resources to effect good stewardship, pointing out that “current UK legislation makes it possible for smaller [pension] plans to join together, but there has been very little movement in that direction”.¹⁸⁰ Simon Wong agreed, noting that Canada already ran a similar system:

At present Canada has an interesting proposal, which is to mandate the transfer of assets from smaller pension funds to a new vehicle as a way to build scale. [...] You have a collective vehicle that hopefully will give you better scale and so reduce costs.¹⁸¹

101. Aviva plc also offered a solution to the cost of effective stewardship. It argued that, under the current regulation, equity commissions which are earned on all trades made by

175 Q 179

176 Q 179

177 Ev 167

178 Ev 167

179 Ev 96

180 Ev 97

181 Q 153

an asset manager may be used to “buy research from any type of provider and this global research spend amounts to \$22bn per year”.¹⁸² It explained:

A few fund managers—including Aviva Investors—are directing this research commission towards brokers and independent research providers of long-term investment research, voting advice and stewardship work. We are clear that such investment in stewardship adds value to investment decisions and is in the long-term interests of our clients.¹⁸³

102. However, this approach remains uncommon and that “those fund managers that do utilise this mechanism tend to spend only a few percentage points of their research commission in this way” because it was not actively encouraged by any official department or regulator.¹⁸⁴ When we asked how this could be encouraged in other firms, Aviva plc responded with four actions for the Financial Conduct Authority (FCA) to consider:

- The FCA could clarify that long-term investment research that is orientated towards good stewardship behaviour by investors can be paid for in this way.
- The FCA could suggest as a guide that it is good practice for a material proportion of the commission research (say 10-25%) to be spent in this way.
- The FCA could say that it is good practice for fund managers to be transparent to their clients that this was taking place.
- The FCA could say that it is good practice for clients to be allowed to opt out of this, as long as they are clear to their beneficial owners what their rationale is for so doing.¹⁸⁵

103. The Secretary of State was clear that he would like to see more resources allocated to stewardship.¹⁸⁶ We asked him about Aviva plc’s proposal and he appeared receptive, telling us that he agreed that better stewardship would “involve a certain amount of investment and the obvious way for the industry to invest would be to make a contribution from its own coffers”.¹⁸⁷

104. The attitude of ‘do the minimum possible’ found in many of our institutional investment firms has hindered the development of good stewardship. Asset managers are currently allowed to use commissions to pay for long-term research, including long-term stewardship, but it appears that few are aware of this. We therefore recommend that the Financial Conduct Authority contacts all major institutional investors highlighting that long-term investment research that is orientated towards good stewardship could (and should) be paid for using a proportion of equity commissions reserved for research.

182 Ev 107

183 Ev 107

184 Ev 107

185 Ev 107

186 Q 355

187 Q 356

Furthermore, we recommend that the FCA sets and publishes an appropriate minimum proportion of a firm's commission allocated to research that should be used towards such activities and an annual list of those firms which do not achieve that level. Those firms will be expected to comply or explain why they have not dedicated the recommended proportion of resources on good long-term stewardship.

The Financial Transaction Tax

105. High Frequency Trading (HFT) is often cited as an example how technological progress has been damaging rather than beneficial to the economy and there have been several attempts to analyse its impact on markets. The Bank of England reported that “HFTs contribute a large amount of both ‘good’ and ‘excessive’ volatility” and concluded that the “welfare implications of HFT are unclear”.¹⁸⁸ In 2011, the Government Office for Science produced a report which sought to answer the question: can high frequency trading lead to financial crashes? It concluded that “it has in the past, and it can be expected to do so more and more in the future”.¹⁸⁹ That Report concluded “the central question of the economic gains (and losses) provided by HFT” should be “considered seriously” and that the Government should:

Use regulations and tax incentives constitute the standard tools of policy makers at their disposal within an economic context to maximize global welfare (in contrast with private welfare of certain players who promote HFT for their private gains).¹⁹⁰

106. A recent report, commissioned by the Department for Business, Innovation and Skills and published by the Government Office for Science, concluded that:

The key message is mixed. The Project has found that some of the commonly held negative perceptions surrounding HFT are not supported by the available evidence and, indeed, that HFT may have modestly improved the functioning of markets in some respects.¹⁹¹

It concluded, however, that “policy makers are justified in being concerned about the possible effects of HFT on instability in financial markets” and recommended that:¹⁹²

European authorities, working together, and with financial practitioners and academics, should assess (using evidence-based analysis) and introduce mechanisms for managing and modifying the potential adverse side-effects of Computer based Trading (CBT) and HFT.¹⁹³

¹⁸⁸ Bank of England, *Working paper 469: High-frequency trading behaviour and its impact on market quality: evidence from the UK equity market*, December 2012, page 22

¹⁸⁹ Government Office for Science, *Crashes and high frequency trading*, August 2011, page 4

¹⁹⁰ Government Office for Science, *Crashes and high frequency trading*, August 2011, page 4

¹⁹¹ Government Office for Science, *The future of computer trading in Financial markets*, October 2012, page 5

¹⁹² Government Office for Science, *The future of computer trading in Financial markets*, October 2012, page 5

¹⁹³ Government Office for Science, *The future of computer trading in Financial markets*, October 2012, page 14

And:

Coordination of regulatory measures between markets is important and needs to take place at two levels:

- Regulatory constraints [involving computer based trading] in particular need to be introduced in a coordinated manner across all markets where there are strong linkages.
- Regulatory measures for market control must also be undertaken in a systematic global fashion to achieve in full the objectives they are directed at.¹⁹⁴

107. We asked Professor Kay whether the Government should introduce a tax on this activity, not to raise revenue, but to influence behaviour. He was clear that:

If we could have a financial transactions tax that worked, it would seem to me to be a very attractive way of discouraging that trading activity in favour of long-term investment.¹⁹⁵

108. However, he went on to explain that it was “very difficult to structure a financial transactions tax that works”.¹⁹⁶ When we spoke to Chris Hitchen, who was a member of Professor Kay’s Advisory Board Team, he told us that this was an area where the team “feared to tread” and had anyway not had time to investigate fully:

Around the table we were reasonably well disposed towards a financial transaction tax, which might help to mitigate that. We did not pursue that, but it is something we definitely picked up.¹⁹⁷

He described the structural problems that Professor Kay had referred to as stemming from the global nature of transactions, summarising that “there are problems with imposing any sort of tax on a partial basis in a global market”.¹⁹⁸ He emphasised that, from his perspective as the Chief Executive of RailPen, he supported a Financial Transaction Tax:

It could potentially take a lot of unnecessary trading out of the system. Who pays for the profits of traders? Ultimately it seems to me it is the end investors; it is my members. Even if we end up paying a small tax on the trades that we do, if it stops us paying for a lot of profits on other peoples’ activities, then we are still better off, net-net.¹⁹⁹

194 Government Office for Science, *The future of computer trading in Financial markets*, October 2012, page 14

195 Q 74

196 Q 74

197 Q 269

198 Q 271

199 Q 272

109. Lord Myners told us that, from his experience of more than a decade analysing the market that he was “drawn towards a financial transaction tax: ideally, one that is established globally”.²⁰⁰ He suggested a solution to the ‘global problem’ that hindered progress during the Kay Review:

We should not allow any bank in a developed country to establish a branch or a subsidiary in an offshore centre that does not comply with the OECD’s white list of financially compliant economies. You could do something similar in terms of transactions.²⁰¹

110. While some representatives from industry agreed that an FTT could be beneficial to the market, they did so with heavy caveats. For example, Steve Waygood from Aviva Investors told us that “we only agree that the financial transaction tax is a good idea if it could be done simultaneously in all key financial jurisdictions”.²⁰² However, he was not confident that this was possible:

Unfortunately the political practicalities of that mean that it might be an academically good idea for Tobin 30 years ago, but the current manifestation of it is not something that we would support.²⁰³

111. Anne Richards, Global Chief Investment Officer of Aberdeen Asset Management told us that HFT should be more closely monitored and linked to the tax system:

There is another subset of market behaviours that have become technologically possible in a way that they were not before and I do not necessarily think that the market processes around the control of that or the taxation rules have kept up with the changes that technology has allowed.²⁰⁴

She conceded that a more consistent tax regime across the wide range of financial instruments (including HFT) could “get around some of these behaviours”, but reached the conclusion that it was “a difficult area to see how you would implement a financial transactions tax in a really beneficial way to the end customer”.²⁰⁵

112. Dominic Rossi, Global Chief Investment Officer at Fidelity Worldwide, did not believe that a FTT would work if its objective was to change behaviour. However, he did say that it would be successful at raising money.²⁰⁶ This ran in direct conflict with the evidence put forward by the Secretary of State:

200 Q 103

201 Q 103

202 Q 273

203 Q 273

204 Q 204

205 Q 207

206 Q 207

Countries like Hungary, France and elsewhere were getting in a fifth or a quarter of the revenue that they thought they would get, because it is so very, very difficult to pin down these transactions and tax them in a sensible way.²⁰⁷

However, when we asked the Secretary of State if he was willing to consider the introduction of an FTT to clamp down on poor practices (for example HFT) rather than simply making money for the exchequer, he was clear:

Yes, I think there is a case, and I am, in some ways, quite disposed to it.²⁰⁸

He also agreed with Professor Kay that “the problem, all along, has been implementing” and drew our attention to the difficulty of identifying which transactions to tax when there were “very rapid electronic transactions” and “cross-border transactions” which were difficult to trace.²⁰⁹

113. There was some support for the concept of a Financial Transaction Tax on trading practices such as High Frequency Trading. However, concerns were raised about the practicality of implementing such a tax unilaterally. We recommend that the Government considers the viability, benefits and risks of a Financial Transaction Tax and commissions research in the following areas:

- i. An impact assessment of the introduction of a Financial Transaction Tax on equities at a level which is the average profit made on a High Frequency Trade in the UK.*
- ii. A impact and feasibility study of the proposal to ban any of those banks which establish branches or subsidiaries in an offshore centre that does not adhere to the OECD’s white list of financially compliant economies from trading in the UK. This should include an assessment of whether doing so would counter the arguments against a domestic FTT being ineffective in the global market.*

Mergers and acquisitions

114. In his report, Professor Kay also considered the impact of mergers and acquisitions. He concluded that

The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves.²¹⁰

The Secretary of State told us that he agreed with the Review’s recommendation:

207 Q 358

208 Q 358

209 Q 358

210 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 62, rec 4

There is a lot of research that tends to show that, probably on balance, it reduces shareholder value, quite apart from any social consequences. However, there is counter-evidence.²¹¹

He concluded that he was “sceptical about the value of takeover activity” but did not want to outlaw it altogether because “if companies are underperforming and their shareholders are being poorly awarded for bad performance, there has to be a mechanism in the market to correct that”.²¹²

115. Professor Kay, however, did draw a distinction:

The openness of the UK acquisition market means that UK companies are a favoured target of global investment banks which seek to promote transactions activity.²¹³

116. He concluded that “UK companies are disproportionately vulnerable to unwanted attention from predators.”²¹⁴ Lord Myners agreed, arguing that the UK regime governing takeovers was very relaxed relative to other countries:

Our rules seem to be extraordinarily permissive, and one might sit back for a moment and ask whether it is actually in the benefit of the economy and society, and why we have concluded that we want to make it so much easier to take over companies than elsewhere.²¹⁵

117. While Lord Myners agreed with Professor Kay’s analysis, he thought that the recommendation could go further. He told us “there is nothing in the Professor’s report that seriously challenges the value and job destruction associated with reckless merger and acquisition activity”.²¹⁶ Lord Myners urged the Government to be wary of all takeover activity, not just that involving foreign companies because “as much damage is done by M&A of British acquirers of British companies as is done by foreign acquirers of British companies”.²¹⁷

118. In his recent report, *No stone unturned in pursuit of growth*, Lord Heseltine recommended that the “Government should do far more to engage with potential foreign investors in our core sectors to secure commitments to developing the UK research, skills and supply base, and in exceptional cases to discourage unwanted investments”.²¹⁸ The Government rejected this:

211 Q 363

212 Q 363

213 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 8.13

214 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 8.13

215 Q 109

216 Q 83

217 Q 109

218 Lord Heseltine, *No stone unturned in pursuit of growth*, October 2012, page 154, rec 73

As a Government, we have rejected the Heseltine recommendation on foreign takeovers. We should not be distinguishing between domestic and foreign ownership. It is not helpful, and some of our best companies are owned by “foreigners”.²¹⁹

119. Professor Kay recommended that the Government should take a more ‘sceptical’ view of the benefits of large takeovers and should be much more proactive in its monitoring of such activity. He drew particular attention to the relative vulnerability of UK companies to takeovers by foreign actors. We recommend that the Government conducts and publishes an assessment of the take-over regimes of other similar economies with a view to learning about the impact that takeovers have had on their companies and economies. Furthermore it should summarise which positive elements may be incorporated into our domestic system to strengthen our economy and ensure that takeovers benefit, rather than damage our economy.

120. The Government has accepted Professor Kay’s recommendation on mergers and acquisitions but it is unclear what specific action it will take. We recommend that the Government clarifies what actions it will take over the next six months to be in a position to effectively monitor all merger activity in the UK. In its response to us, the Government should outline what action it will take to engage with companies and their investors to ensure that any investment merger activity is to the long-term benefit of the UK economy.

Box 2: A case study of The Cadbury / Kraft takeover as reported in the Financial Times.

An illustration of how short-term shareholders have influenced the UK equity market and the fate of a successful British company:

The story

In 2009, US food company Kraft Foods launched a hostile bid for Cadbury, the UK-listed chocolate maker. As became clear almost exactly two years later in August 2011, Cadbury was the final acquisition necessary to allow Kraft to be restructured and indeed split into two companies by the end of 2012: a grocery business worth approximately \$16bn; and a \$32bn global snacks business. Kraft needed Cadbury to provide scale for the snacks business, especially in emerging markets such as India. The challenge for Kraft was how to buy Cadbury when it was not for sale.

The history

Kraft itself was the product of acquisitions that started in 1916 with the purchase of a Canadian cheese company. By the time of the offer for Cadbury, it was the world's second-largest food conglomerate, with seven brands that each generated annual revenues of more than \$1bn.

Cadbury, founded by John Cadbury in 1824 in Birmingham, England, had also grown through mergers and demergers. It too had recently embarked on a strategy that was just beginning to show results. Ownership of the company was 49 per cent from the US, despite its UK listing and headquarters. Only 5 per cent of its shares were owned by short-term traders at the time of the Kraft bid.

The challenge

Not only was Cadbury not for sale, but it actively resisted the Kraft takeover.

Sir Roger Carr, the chairman of Cadbury, was experienced in takeover defences and immediately put together a strong defensive advisory team. Its first act was to brand the 745 pence-per-share offer “unattractive”, saying that it “fundamentally undervalued the company”. The team made clear that even if the company had to succumb to an unwanted takeover, almost any other confectionery company (Nestlé, Ferrero and Hershey were all mentioned) would be preferred as the buyer. In addition, Lord Mandelson, then the UK's business secretary, publicly declared that the government would oppose any buyer who failed to “respect” the historic confectioner.

The response

Cadbury's own defence documents stated that shareholders should reject Kraft's offer because the chocolate company would be “absorbed into Kraft's low growth conglomerate business model—an unappealing prospect that sharply contrasts with the Cadbury strategy of a pure play confectionery company”.

Little did Cadbury's management know that Kraft's plan was to split in two to eliminate

its conglomerate nature and become two more focused businesses, thereby creating more value for its shareholders.

The result

The Cadbury team determined that a majority of shareholders would sell at a price of roughly 830 pence a share. A deal was struck between the two chairmen on January 18 2010 at 840 pence per share plus a special 10 pence per share dividend. This was approved by 72 per cent of Cadbury shareholders two weeks later.

The key lessons

As this deal demonstrates, these shareholders may not (and often will not) be the long-term traditional owners of the target company stock, but rather very rational hedge funds and other arbitrageurs (in Cadbury's case, owning 31 per cent of the shares at the end), who are swayed only by the offer price and how quickly the deal can be completed. Other stakeholders may have legitimate concerns that need to be addressed but this can usually be done after the deal is completed, as Kraft did.²²⁰

121. We followed closely the Cadbury / Kraft takeover and published two Reports on the matter.²²¹ At the beginning of that takeover, only five percent of owners were considered 'short-term'. By the time the takeover went through this figure was more than 31 per cent.²²²

122. Professor Kay analysed the problem of short-term investors essentially forcing takeovers of companies against the wishes of longer-term shareholders. He considered solving this problem through 'differential voting rights' on shares:

One suggestion was that voting rights should accrue only after being on the share register for a specified period. This might be a general rule or one specifically applicable during takeover.²²³

However, he concluded that this was not practicable because "the introduction of such provisions by legislation or regulation would involve practical difficulties and would be unlikely to achieve the intended effect".²²⁴ He also believed that regulation would be unnecessary should his recommendations on good stewardship bear fruit.²²⁵

123. Many expert witnesses agreed with this perspective. Anita Skipper, Corporate Governance Advisor for Aviva Investors, told us that the "one share, one vote principle is

220 Financial Times, *Case study: Kraft's takeover of Cadbury*, 9 January 2012 [extracts]

221 Business, Innovation and Skills Committee, Ninth Report of Session 2009–10, *Mergers, acquisitions and takeovers: the takeover of Cadbury by Kraft* and Business, Innovation and Skills Committee, Sixth Report of Session 2010–12, *Is Kraft working for Cadbury?*

222 Financial Times, *Case study: Kraft's takeover of Cadbury*, 9 January 2012

223 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 8.32

224 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 8.32

225 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 8.32

the fairest principle”.²²⁶ She argued that introducing differential voting rights would introduce new problems:

There are too many problems once you start giving out differential voting rights, and things that are not actually supportive of what we are trying to do here. You could entrench management whom you are trying to persuade to change what they are doing.²²⁷

Neil Woodford agreed, and argued that in this case the market had worked efficiently:

The long-term shareholders who owned Cadbury decided that the price that was being offered was attractive enough for them to sell their shares, because there is always, of course, an opportunity cost associated with investment. You can take your capital from your particular investment and deploy it more productively elsewhere.²²⁸

124. We asked the Secretary of State if he had considered whether to give preference to long-term investors over short-term investors. He told us that his “instincts are to go back to it”.²²⁹ However, he identified three specific obstacles to differentiating voting rights during the takeover of a company:

- If you stop the short-term investors, you reduce the demand for shares, you drive down the share price and you then make the takeover more attractive.
- If you stop long-term investors from acquiring shares in order to build up their stake in the company during the takeover period.
- We do not have an effective system, at the moment, for distinguishing between nominees and original owners. In the UK, we do not have that, so it is not possible to divide the share register in the way that one would ideally like.²³⁰

He closed his evidence asking us to “help me by finding a way past them”.²³¹

125. We have heard evidence that the ‘one-share one-vote’ is fairest. Some witnesses pointed out to us that the long-term shareholders must choose to sell to short-term traders and argued that the ‘market’ ruled. However we cannot help but think back to the evidence that we have heard that, overall, takeovers detract value from companies. The Secretary of State told us that his instinct was to go back and consider introducing

226 Q 256

227 Q 256

228 Q 260

229 Q 330

230 Q 330

231 Q 330

differential votes (i.e. encouraging the principle that short-term traders should have no influence over the takeover vote).

126. We recommend that the Department produces a feasibility study which clearly outlines the risks and benefits of introducing a policy that differentiates between shareholders and voting rights based on the length of time a share has been held.

127. We further recommend that the Government commissions a study to set out the impact on the UK of foreign takeovers of British companies over the past 25 years.

6 Measuring success

Moving forward

128. At the beginning of this Report we challenged the Government to ensure progress in the implementation of Professor Kay’s recommendations. The Government set out its intentions in its written evidence to us:

The Government response commits the Government to publish an update, in summer 2014, setting out what further progress has been achieved by government and others, to consider Professor Kay’s directions for regulatory policy and to deliver his specific recommendations.²³²

129. Lord Myners was in a similar position to Professor Kay ten years ago. His Review received similar support and promise of follow-up from the Government at the time but many of his recommendations were not implemented. Lord Myners told us that he had been “very disappointed” by that lack of progress.²³³ He believed that the Kay Review “relied on the same statements on principles of best practice” that he had relied on, and that little would happen unless there was a “forcing mechanism”.²³⁴ In particular he argued that the Government needed to “get much more involved and engaged”.²³⁵

130. Dominic Rossi, Global Chief Investment Officer at Fidelity Worldwide, hoped that the Review would be built on and suggested that the Government and the industry should both be held to account for progress in three specific areas:

- Stewardship. Too many asset managers, as I have said already, view their responsibility solely to be that of investment performance rather than also improving the performance of the companies in which they invest.
- Short-termism. By asset managers getting closer to the end client and strengthening our direct relationships with the end client we will improve persistency of assets, and that will have a spin-off in terms of the investment time period.
- Remuneration. Corporate remuneration is too complex and too short-term.²³⁶

131. Although the National Association of Pension Funds Limited believed that “by endorsing Professor Kay’s recommendations the Government is giving a clear direction of

232 Ev 86

233 Q 84

234 Q 129

235 Q 129

236 Q 174

travel”,²³⁷ others were more sceptical. For example the UK Shareholders Association told us that:

Very little is likely to be achieved without a strong push from Government. Moreover any review dependent on ‘market participants’ will surely be biased towards the interests of the financial services industry, which largely conducts its affairs with other people’s money; those whose money it usually is, namely private investors and savers, are usually absent from such reviews and so need the Government to act on their behalf.²³⁸

It went on to recommend that:

A positive way forward would have been for the Secretary of State to call industry leaders together to bring their influence to bear in establishing these principles and threatening them with legislation if they failed to do so. [...] There is no indication in the Response of any one individual or Department having been given any power or responsibility to drive this forward.²³⁹

132. The Association of General Counsel and Company Secretaries of the FTSE 100 appeared to agree, but urged the Government to remember that “in addition to the domestic framework, the UK equity markets are subject to regulation at the European and international level” and that:

Although we believe that many of the recommendations in the Kay Review and the Government’s response are commendable, it is imperative that any specific proposals flowing from the Kay Review be formulated and implemented in this context.²⁴⁰

133. We asked the Secretary of State how he saw the market evolving after the Kay Review, and whether he would seek any power to influence the industry if it did not change voluntarily. He replied that “there is no obvious big stick to wave”,²⁴¹ but went on to explain that he wanted to “encourage” change rather than compel it:

I would strongly encourage them to participate in that and make sure it works. I would also strongly encourage them to listen to the statements of best practice that have emerged from the representative bodies in the industry, because that is how standards are raised.²⁴²

He went on to outline the minimum progress that he expected to make by the summer of 2014 (two years after the publication of the Kay Review):

237 Ev 122

238 Ev 134

239 Ev 134

240 Ev 115

241 Q 319

242 Q 318

I would have thought that the minimum is:

- That the investors' forum, which is at the heart of Kay's recommendations, would be up and running and functioning, and we would be able to see a discernible impact.
- That the various statements of good conduct that have been issued by the trade bodies will be in place and will have been visibly acted upon.
- That, at roughly the same time, we would have a clear conclusion from the Law Commission.²⁴³

134. Lord Myners' Review was published more than a decade ago and yet we find ourselves examining the same issues and principles in the Kay Review today. Professor Kay's findings and proposals must not be 'kicked into the long grass' by the Government or the industry. Professor Kay's specific recommendations need to be acted on and we will hold those responsible to account. Where Professor Kay has provided overarching principles these need to be turned into actions. The Secretary of State has assured us that there is an appetite for change in the Government and we have heard that this is mirrored in the industry. Therefore, there can be no excuse for inaction by either the Government or the industry.

135. We recommend that the Government immediately publishes clear, measurable and achievable targets for implementation of the Kay Review. In particular, in its response to this Report, the Government must outline for each of Professor Kay's 17 recommendations what needs to have been achieved by the Government's review of progress in 2014.

Regulatory or voluntary approach?

136. A recurrent theme in this inquiry was how to get the right balance between regulation and voluntary change in implementing Professor Kay's recommendations and principles. In his Review, Professor Kay was clear that he favoured giving the industry an opportunity to change without calling for legislation:

We have tried to avoid prescriptive regulation wherever possible in framing these recommendations. We believe the lesson of recent financial crises is that the cultural changes we seek can be achieved only by changing the structure of the industry and the incentives of those who work in it, not by ever more prescriptive rule books of behaviour.²⁴⁴

Professor Kay based this view on his belief that regulation could create perverse incentives for players in the equity market and had been a cause for lengthening the chain of investment. He stated that "the existing structure of the investment chain is the product of

243 Q 377

244 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 13.16

a highly regulated environment” and that this had spiralled out of control because additional layers of oversight had been required:²⁴⁵

If we want to establish trust relationships as the basis of financial services—and I believe we do—we cannot regulate trust relationships very easily. We need to set up structures and environments in which people can develop them and in which they are encouraged to develop them, rather than the one we have at the moment in which people are going through large amounts of compliance based form filling and box ticking.²⁴⁶

137. Professor Kay summarised that while he did “not seek either more or less regulation” he expected the “long-run outcome” of his approach to be “less regulation”.²⁴⁷ He told us that there were two main disadvantages to legislating for change compared to encouraging it on a voluntary basis:

One is that they are inflexible—not all of these regulations will be applicable to all situations and all companies.

The other is that people will be inclined to believe that, so long as they have complied in a formal sense, then they have done their job.²⁴⁸

The Government agreed:

The Government response makes clear that the necessary changes in culture cannot simply be achieved through regulation, but rather through the development of good practice in the investment chain. The Government is therefore promoting Professor Kay’s Good Practice Statements for company directors, asset managers and asset holders, as the starting point for industry-led standards of good practice.²⁴⁹

138. Perhaps unsurprisingly, many of the industry practitioners agreed with Professor Kay and told us that they were concerned about burdening the sector with regulation. For example Neil Woodford, Head of UK Equities in Invesco Perpetual, told us that he was “instinctively concerned about too much regulation”.²⁵⁰ He went on to say that regulation “in and of itself alone” would not deliver the desired outcomes because what was needed was a “whole structural change in terms of incentive structures in the industry”.²⁵¹ The Chartered Institute of Personnel and Development agreed:

245 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 5.36

246 Q 17

247 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 12.4

248 Q 21

249 Ev 85

250 Q 253

251 Q 253

Changing an organisation’s culture fundamentally requires changes in leadership behaviours and cannot happen overnight, but it begins at the top and is reinforced through performance measures and reward practices.²⁵²

139. Daniel Godfrey, the Chief Executive of the Investment Management Association warned that firms could hide behind compliance with regulation without actually changing their culture:

We can put in place things that make it look like things are happening really easily through regulation, but real progress will come from belief—people believing it will work—and also pressure from the demand side because they believe it will work, and that is entirely achievable over a period of time.²⁵³

140. Albion Ventures LLP argued that “changes should be cultural rather than legislative” and asserted that it was essential that investors were “not deterred by excessive regulatory red tape or other investment barriers”.²⁵⁴ Matthew Fell, the Director of Competitive Markets for the CBI, stated that better engagement could not be forced by any Government:

On the balance between regulation and advocacy, if the task in hand is really to drive up high-quality engagement, I struggle to see how you actually generate those sorts of conversations through regulation.²⁵⁵

141. On the other hand, several witnesses told us that the industry had had long enough to enact change for itself and that the Government should now be firmer in its approach. For example, the UK Shareholders Association told us that it was “essential that the Government legislates to remove the obstacles to what should be investors’ right to be treated as full shareholders”.²⁵⁶ FairPensions (now ShareAction) took this point further and suggested specific areas where formal change (be it regulation or legislation) was needed:

- Pension funds should be obliged to report to their beneficiaries not just on their investment and voting policies (as now), but also on how those policies have been implemented on an annual basis.
- Government should exercise its reserve power to introduce mandatory voting disclosure for institutional investors.
- Institutional investors could be obliged to hold annual meetings (in the same way that companies must hold annual meetings for their shareholders) offering savers the opportunity to hold their fiduciaries to account.

252 Ev 137

253 Q 310

254 Ev 91

255 Q 310

256 Ev 135

- Government could explore ways to support and strengthen the role of member-nominated trustees, and to extend similar member representation to contract-based forms of pension provision.²⁵⁷

Lord Myners added to this list, telling us that the “Government should force the creation of this investor forum, and it should say that the financial means will be placed there for it”.²⁵⁸

142. The Government was clear in its support of Professor Kay’s ‘voluntary first—legislate later’ approach. When we spoke to the Secretary of State, however, he told us that there was a balance to be found and that regulation could be introduced alongside cultural changes. He clarified the areas that he was prepared to legislate in and those he would leave to the industry:

There is a two-track approach to most of these questions. In the mandatory area, of course, we have the legislation on executive pay, and narrative reporting is coming into effect as well.²⁵⁹

He went on to tell us that:

There are key areas of corporate behaviour that have to be regulated, and are regulated, but for other areas, where subtle changes are involved, the voluntary approach works well, as it is the best solution and it works.²⁶⁰

The Secretary of State was slightly more firm however, on the consequences for the industry if it did not change:

I do not have any problem with adopting tough regulatory solutions when voluntary methods have failed and we have demonstrated that in one or two areas, with executive pay being the most obvious one. [...] My approach to all these things [...] is to try the voluntary approach and try to build up trust with the practitioners. If it fails, we can adopt more aggressive solutions, but let us try the voluntary approach first.²⁶¹

143. In considering the merits of a voluntary approach versus a statutory one, it is worth returning to the Myners Review of 2001:

The review therefore believes it is important at least to attempt to seek an effective approach which does not rely on direct Government intervention in banning or directly determining behaviour.²⁶²

In 2012, Professor Kay wrote:

257 Ev 114

258 Q 92

259 Q 349

260 Q 349

261 Q 383

262 Lord Myners, *Myners Review of institutional investment: Final Report*, March 2001, page 2

The Review believes that it is generally more effective, and in the long-term less intrusive, to give incentives to do the right thing than to attempt to prevent people who are subject to inappropriate incentives from doing the wrong thing.²⁶³

144. We sympathise with Professor Kay and the Secretary of State’s concerns that over prescription and formal legislation risk alienating the UK equity market in a global environment, providing false security through ‘tick-boxing’ and distorting the effective operation of the market. However, we have yet to be convinced that all of the major players in the institutional investment sector are committed to significant voluntary reform.

145. We agree that the industry should be given a chance to change of its own volition but the experience of the Myners Review does not fill us with confidence. A cultural change will not happen without a catalyst. Ministers must be willing, and seen to be willing, to pick up a ‘regulatory stick’ should progress stall. We reiterate our recommendations that the Government has to set out a timetable for reform which includes the following for every one of Professor Kay’s recommendations:

- *a clear measure of success for the recommendation (the target);*
- *who is responsible for achieving the target;*
- *a clear deadline by which the target needs to be achieved; and*
- *the action that the Government will take if the target is not achieved.*

263 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 6.17

Conclusions and recommendations

In the report conclusions are shown in **bold**, recommendations are shown in ***bold italics***. In this list, recommendations are shown in *italics*.

Previous review of the market

1. In the 12 years since the Myners Review, little has changed in the role and actions of institutional shareholders. The recommendations and findings of the Kay Review cannot be ignored or diluted as we have heard the Myners Review was. The similarities between the remit of the Kay review and that of the Myners Review demonstrate that little progress has been made to reform the sector. It is therefore critical that they do not share a similar fate. The Government must play an active role to drive reform on implementation of Professor Kay's recommendations. Our Report, therefore, concentrates on where that activity must take place. (Paragraph 14)

Investors Forum

2. *We agree with Professor Kay and the Government that collective engagement is to the benefit of the equity market and UK businesses. However, we are concerned that the hands-off approach taken by the Government runs the risk that progress will stall. The Government has provided no remit, deadline or resource for the Investor's Forum and the 'working group' to investigate the concept of the Investor's Forum will not report until later in 2013. The Government has told us that it will publish an update on progress in the summer of 2014. We recommend that the Government outlines a clear timetable for setting up the Forum before that point, engaging with different types of investors, along with milestones and assigned responsibilities for achieving this.* (Paragraph 27)

Fiduciary duty

3. *The Law Commission is currently consulting on the legal definition of fiduciary duty and will not report back until June 2014. We believe that this is too slow. We recommend that the Government liaises with the Law Commission to bring forward the timing of this project. The Government is paying up to £140,000 for this project and we expect it to push for the highest value for the taxpayer's money. The Law Commission will launch a three month consultation in October 2013. We suggest that it gives this issue the appropriate priority and publishes its final definition in the first quarter of 2014.* (Paragraph 36)

Appointment of executives

4. *Professor Kay has provided a clear recommendation, proposing that companies consult with major investors over all board appointments and the Government has agreed to implement this. We therefore recommend that the Government publishes a timetable for the implementation of this policy, clarifies which investors companies are to consult*

with and outlines how it intends to combat the issues surrounding insider trading and confidentiality which inevitably accompany such board appointments. Alongside this, the Government should undertake an impact assessment, particularly looking at the possible increase of bureaucratic burdens on small businesses and, if necessary, introduce an opt-out clause for them. (Paragraph 43)

Remuneration of executives

5. The Government has accepted the principles underlying Professor Kay's recommendation on the remuneration of executives. We are therefore disappointed that it has failed to take the action to see it put into practice or responsibility for its implementation. We are not persuaded by the Government's view that businesses will see the benefit of this recommendation and will adopt this measure voluntarily. (Paragraph 52)
6. *We support the recommendation that company directors should be tied into the long-term performance of their companies through time-appropriate shares. Since the Government has accepted Professor Kay's analysis and agreed with his findings, it should reconsider its response and take an active approach to its implementation. In particular, we recommend that the Government outlines how it intends to combat the issue of directors using options and derivatives to avoid these rules. Alongside this the Government should outline how it will ensure that departing directors will not be perversely incentivised to artificially inflate the share price immediately prior to their retirement or retire early to realise the locked-in value of their shares. (Paragraph 53)*

Incentivising fund managers

7. The incentives driving the actions of fund managers are one of the most important factors within the investment chain. Professor Kay made a specific recommendation on this but the Government has shied away from accepting it, citing an unwillingness to prescribe pay structures. While this may be understandable, it is clear that the Government must be involved; at the very least encouraging a cultural shift away from short-term to long-term performance-based pay. (Paragraph 62)
8. *We recommend that the Government takes a harder line when framing the culture in which fund managers work by highlighting best practice where it sees it. We further recommend that it should work towards the goal that fund manager performance be reviewed over longer time horizons than the typical quarterly cycle. (Paragraph 63)*
9. *One way that the Government can help effect a culture change in the incentives driving fund-manager behaviour is to develop and publish a set of long-term measures of success alongside options for sanctions for demonstrable failure. We recommend that it does so, and then annually publishes a list of those firms that have fully adopted such measures. This would provide a different measure of success to the very short-term ones which are currently available. (Paragraph 64)*

Quarterly reporting

10. *We support Professor Kay's recommendation that the requirement for quarterly reporting should be removed and recommend that the Government now outlines a clear timetable to implement this recommendation including what alternative strategies would be followed in the absence of any change in EU law. (Paragraph 70)*
11. *We recommend that the Government sets out details of progress in negotiations with other international accounting standard bodies (such as the U.S. Securities and Exchange Commission) on the requirement for quarterly reporting to ensure that any changes made to the domestic or EU-wide accounting practices are accepted on a global level. (Paragraph 71)*

Narrative Reporting

12. *We recommend that the Government sets out how it will ensure that enhanced narrative reporting will remain consistent with, and accepted by, overseas regulators, for example the US Securities and Exchange Commission. (Paragraph 78)*
13. *When the proposed changes are made to the structure and format of reporting, the Government (through the Financial Reporting Council) will need to ensure that any accompanying guidance on the new provisions included clear minimum standards to ensure comparability. The Government must not shy away from strict enforcement of these standards. The scrutiny and consistency of narrative reports may be harder than that of reports containing only information about pounds and pence, but the Government must ensure high standards are maintained. We therefore recommend that the Government outlines how it proposes to implement auditing and monitoring of narrative reports. Ongoing shareholder scrutiny and transparency must be at the heart of this. These processes must be in place before the proposed changes come into effect. (Paragraph 79)*

The Stewardship Code: Content

14. *In its current form, the Stewardship Code contains seven voluntary principles which represent the minimum benchmark for the relationship between owners and investment managers. Professor Kay recommended that the Code should be developed to take account of strategic issues as well as those around corporate governance. We recommend that this be implemented through a formal consultation by the Financial Reporting Council. It is essential that the Code is accepted by all players of the equity market, therefore all such participants must have a say in its development. Having considered the evidence and suggestions from many players in the market, we specifically recommend that the Code be enhanced:*

- *To allow investment managers to focus on strategic issues facing companies within their policies on how they discharge their stewardship responsibilities (rather than the current focus on profit, which is inherently short-term).*

- *To include the principle that engagement and corporate governance should extend beyond financial affairs and encompass more long-term value adding activities such as environmental, social and governance factors.*
- *To include the provision that institutional investors and significant owners should be members of at least one Investor’s Forum.*
- *Related to the previous point, to include the role of institutional investors to engage in potential systemic risks to the UK equity market rather than only engaging with risks to individual companies in their portfolio.*
- *To redefine a clearer explanation of conflicts of interest and in particular for asset management firms to publish how key conflicts of interest are managed in practice.*
- *To provide one clear and authoritative definition of the term ‘stewardship’.* (Paragraph 85)

The Stewardship Code: Sign-up

15. *Progress has been made in terms of the number of asset managers signing up to the Stewardship Code. However, sign-up among owners remains low. We recommend that the Government:*

- *Outlines what it considers a minimum acceptable level of sign up to the Stewardship Code (making provision for the distinction between manager and owner).*
- *Makes clear that it is government policy to encourage sign-up to the Code and publishes a clear target (and timescale) of success. This timescale should be no longer than two years.*
- *Outlines clearly what action it will take if this target is not met by the market on a voluntary basis.* (Paragraph 89)

16. Finally, some witnesses pointed out that, at the time of our inquiry, the Parliamentary Contributory Pension Fund (PCPF) was not signed up to the Stewardship Code. Penny Shepherd, Chief Executive of UKSIF, told us that “one area in which this House can act to raise awareness is by acting as an exemplar of good practice”. We are pleased to take this opportunity to formally welcome the fact that the trustees of this fund have made the decision to sign up to the Stewardship Code in the near future. We will continue to monitor this. (Paragraph 90)

The Stewardship Code and Professor Kay’s good practice statements

17. We support Professor Kay’s Good Practice Statements and agree that the industry, asset holders and company directors should be given the opportunity to formally embrace the principles that are contained within them. However, we are conscious that many individuals and firms are already signed up to the Stewardship Code and we are concerned that yet another voluntary compliance statement will be

submerged by a rising tide of self-regulation and codes of best practice. The market requires clarity and certainty and we are concerned about over-burdening it with regulation and codes. (Paragraph 97)

18. *Professor Kay's Good Practice Statements should be the standard level of behaviour for the industry and all players in the UK equity market. We expect the Government, in its response to this Report, to outline its timetable for all companies to sign up to Professor Kay's Good Practice Statements. If this target is not met, the Government should be prepared to incorporate Professor Kay's Good Practice Statements into the already established Stewardship Code. (Paragraph 98)*

Resourcing stewardship

19. *The attitude of 'do the minimum possible' found in many of our institutional investment firms has hindered the development of good stewardship. Asset managers are currently allowed to use commissions to pay for long-term research, including long-term stewardship, but it appears that few are aware of this. We therefore recommend that the Financial Conduct Authority contacts all major institutional investors highlighting that long-term investment research that is orientated towards good stewardship could (and should) be paid for using a proportion of equity commissions reserved for research. Furthermore, we recommend that the FCA sets and publishes an appropriate minimum proportion of a firm's commission allocated to research that should be used towards such activities and an annual list of those firms which do not achieve that level. Those firms will be expected to comply or explain why they have not dedicated the recommended proportion of resources on good long-term stewardship. (Paragraph 104)*

The Financial Transaction Tax

20. *There was some support for the concept of a Financial Transaction Tax on trading practices such as High Frequency Trading. However, concerns were raised about the practicality of implementing such a tax unilaterally. We recommend that the Government considers the viability, benefits and risks of a Financial Transaction Tax and commissions research in the following areas:*
- *An impact assessment of the introduction of a Financial Transaction Tax on equities at a level which is the average profit made on a High Frequency Trade in the UK.*
 - *A impact and feasibility study of the proposal to ban any of those banks which establish branches or subsidiaries in an offshore centre that does not adhere to the OECD's white list of financially compliant economies from trading in the UK. This should include an assessment of whether doing so would counter the arguments against a domestic FTT being ineffective in the global market. (Paragraph 113)*

Mergers and acquisitions

21. *Professor Kay recommended that the Government should take a more ‘sceptical’ view of the benefits of large takeovers and should be much more proactive in its monitoring of such activity. He drew particular attention to the relative vulnerability of UK companies to takeovers by foreign actors. We recommend that the Government conducts and publishes an assessment of the take-over regimes of other similar economies with a view to learning about the impact that takeovers have had on their companies and economies. Furthermore it should summarise which positive elements may be incorporated into our domestic system to strengthen our economy and ensure that takeovers benefit, rather than damage our economy. (Paragraph 119)*
22. *The Government has accepted Professor Kay’s recommendation on mergers and acquisitions but it is unclear what specific action it will take. We recommend that the Government clarifies what actions it will take over the next six months to be in a position to effectively monitor all merger activity in the UK. In its response to us, the Government should outline what action it will take to engage with companies and their investors to ensure that any investment merger activity is to the long-term benefit of the UK economy. (Paragraph 120)*
23. *We have heard evidence that the ‘one-share one-vote’ is fairest. Some witnesses pointed out to us that the long-term shareholders must choose to sell to short-term traders and argued that the ‘market’ ruled. However we cannot help but think back to the evidence that we have heard that, overall, takeovers detract value from companies. The Secretary of State told us that his instinct was to go back and consider introducing differential votes (i.e. encouraging the principle that short-term traders should have no influence over the takeover vote). (Paragraph 125)*
24. *We recommend that the Department produces a feasibility study which clearly outlines the risks and benefits of introducing a policy that differentiates between shareholders and voting rights based on the length of time a share has been held. (Paragraph 126)*
25. *We further recommend that the Government commissions a study to set out the impact on the UK of foreign takeovers of British companies over the past 25 years. (Paragraph 127)*

Measuring success

26. *Lord Myners’ Review was published more than a decade ago and yet we find ourselves examining the same issues and principles in the Kay Review today. Professor Kay’s findings and proposals must not be ‘kicked into the long grass’ by the Government or the industry. Professor Kay’s specific recommendations need to be acted on and we will hold those responsible to account. Where Professor Kay has provided overarching principles these need to be turned into actions. The Secretary of State has assured us that there is an appetite for change in the Government and we have heard that this is mirrored in the industry. Therefore, there can be no excuse for inaction by either the Government or the industry. (Paragraph 134)*
27. *We recommend that the Government immediately publishes clear, measurable and achievable targets for implementation of the Kay Review. In particular, in its response*

to this Report, the Government must outline for each of Professor Kay's 17 recommendations what needs to have been achieved by the Government's review of progress in 2014. (Paragraph 135)

Regulatory or voluntary approach

- 28.** We sympathise with Professor Kay and the Secretary of State's concerns that over prescription and formal legislation risk alienating the UK equity market in a global environment, providing false security through 'tick-boxing' and distorting the effective operation of the market. However, we have yet to be convinced that all of the major players in the institutional investment sector are committed to significant voluntary reform. (Paragraph 144)
- 29.** *We agree that the industry should be given a chance to change of its own volition but the experience of the Myners Review does not fill us with confidence. A cultural change will not happen without a catalyst. Ministers must be willing, and seen to be willing, to pick up a 'regulatory stick' should progress stall. We reiterate our recommendations that the Government has to set out a timetable for reform which includes the following for every one of Professor Kay's recommendations:*
- *a clear measure of success for the recommendation (the target);*
 - *who is responsible for achieving the target;*
 - *a clear deadline by which the target needs to be achieved; and*
 - *the action that the Government will take if the target is not achieved.* (Paragraph 145)

7 Annex A: Professor Kay's Principles

1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance;
2. Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements;
3. An investors' forum should be established to facilitate collective engagement by investors in UK companies;
4. The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves;
5. Companies should consult their major long-term investors over major board appointments;
6. Companies should seek to disengage from the process of managing short-term earnings expectations and announcements;
7. Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden;
8. Asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund;
9. The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers;
10. All income from stock lending should be disclosed and rebated to investors;
11. Mandatory IMS (quarterly reporting) obligations should be removed;
12. High quality, succinct narrative reporting should be strongly encouraged;
13. The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations;
14. Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment;
15. Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be

provided only in the form of company shares to be held at least until after the executive has retired from the business;

16. Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund; and
17. The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.²⁶⁴

²⁶⁴ Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 12

8 Annex B: Summary of the Kay Review's recommendations

In his final Report, Professor Kay made 17 recommendations. Each of these is outlined below,²⁶⁵ followed by a summary of the government response:

1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance;

*The FRC regularly reviews the implementation and impacts of its Codes, and will produce its next report on developments in Corporate Governance and Stewardship in December this year. In light of this and future exercises it will consider whether further changes to the Stewardship Code may be desirable in due course to reflect Professor Kay's recommendation.*²⁶⁶

2. Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements;

*The Government supports this recommendation. The development and promotion of good practice in the investment chain is central to achieving the culture shift that Professor Kay advocates. Professor Kay's suggested Good Practice Statements—aimed at company directors, asset managers and asset holders in turn—provide a starting point from which to achieve this.*²⁶⁷

3. An investors' forum should be established to facilitate collective engagement by investors in UK companies;

*The Government intends to ask a small group of respected senior figures from business and the investment industry to review industry progress, including that made by institutional investors on shareholder engagement, both collectively and individually, and to assess companies' perception of the extent and quality of this engagement. This review will complement the Government's progress report in Summer 2014.*²⁶⁸

4. The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves;

²⁶⁵ Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 13

²⁶⁶ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.5

²⁶⁷ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.6

²⁶⁸ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.18

*The Government accepts this recommendation, and welcome Professor Kay's thoughtful analysis of the impact of mergers and acquisitions on UK companies.*²⁶⁹

5. Companies should consult their major long-term investors over major board appointments;

*The Government agrees with the Kay Report that efforts by companies to consult their shareholders in advance of making major appointments to the board is consistent with developing long-term trust-based relationships that support engagement in pursuit of sustainable value creation. The establishment of an investor forum, as suggested by Professor Kay, may provide a means for such consultation to take place, but it need not be the only means. Many companies already consult shareholders on board appointments in the context of wider engagement activity and this is to be welcomed.*²⁷⁰

6. Companies should seek to disengage from the process of managing short-term earnings expectations and announcements;

*The Government supports this recommendation, which again represents good practice for companies. This recommendation has also been appended to the Good Practice Statement for Company Directors published alongside this response.*²⁷¹

7. Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden;

*The Government accepts the view that there should be common minimum standards of behaviour required of all investment intermediaries, but believes that describing these standards as 'fiduciary' has the potential to cause some confusion.*²⁷²

8. Asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund;

*The Government agrees with Professor Kay that there should be transparency of all costs and charges in the investment chain and are therefore supportive of this recommendation. This recommendation is reflected in the Good Practice Statement for Asset Managers, signalling Professor Kay's intention to improve transparency through the development of industry good practice.*²⁷³

²⁶⁹ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.19

²⁷⁰ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.28

²⁷¹ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.31

²⁷² Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.34

²⁷³ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.37

9. The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers;

*The Government [...] accepts this recommendation and has asked the Law Commission to undertake a review of the legal obligations arising from fiduciary duties (and more widely) that dictate what considerations are appropriate for trustees and other investment intermediaries seeking to act in their clients' best interests.*²⁷⁴

10. All income from stock lending should be disclosed and rebated to investors;

*The Government supports this approach and would like to see separate disclosure of stock lending costs and income endorsed by the industry in the context of the development of a more comprehensive industry-led disclosure regime, as discussed above. The Government's progress report in Summer 2014 will assess to what extent the investment industry has responded to this recommendation and what further action might be appropriate in the context of relevant EU policy developments in this area.*²⁷⁵

11. Mandatory IMS (quarterly reporting) obligations should be removed;

*The Government has already made clear its strong support for the [European] Commission's proposal [to amend the EU Transparency Directive] and will therefore take forward work to deliver this recommendation in the context of ongoing negotiations with the Commission and EU Member States. UK implementation of the proposed changes would fall to the FCA and be subject to consultation and cost-benefit analysis.*²⁷⁶

12. High quality, succinct narrative reporting should be strongly encouraged;

*The Government supports this recommendation. We are already focused on this policy objective, which was the subject of a Coalition Government commitment, and have carried out two consultation exercises in the past two years. [...] The Government published draft regulations to bring about the changes to the structure and format of reporting on 18 October 2012, with the intention of bringing these into effect in October 2013. We will be working closely with the FRC as they develop the guidance on the new provisions.*²⁷⁷

13. The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations;

The Government will [...] explore with market participants, the regulators, academics and relevant representative and professional bodies how best to stimulate more debate

²⁷⁴ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.44

²⁷⁵ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.50

²⁷⁶ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.51

²⁷⁷ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, paras 3.53 & 3.56

*and economic analysis in this area. We expect to set out further proposals early in the new year.*²⁷⁸

14. Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment;

*Recommendation 14 has potentially wide-ranging implications for regulatory policy and will therefore be considered in more detail by the relevant government departments and independent regulators, alongside the broader directions for regulatory policy.*²⁷⁹

15. Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business;

*The Government agrees that the structure of remuneration should be determined by individual companies in consultation with their shareholders and that agreeing and sharing good practice is the appropriate way to promote change in this area. The Government does not believe there is a case for blanket regulation of the structure of company directors' remuneration and believes that companies and their shareholders need flexibility to negotiate outcomes that work for them. The Government's comprehensive reforms to the governance framework for directors' remuneration will help to support change in this area.*²⁸⁰

16. Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund;

*Professor Kay's stated intention to shift the culture of asset manager pay through the development of industry good practice, rather than by imposing pay structures in regulation. Recommendation 16 is therefore reflected in the Kay Good Practice Statement for Asset Managers. The Government will encourage asset managers to adopt such models by promoting consideration of the Kay Good Practice Statement for Asset Managers.*²⁸¹

17. The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.

²⁷⁸ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.59

²⁷⁹ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.60

²⁸⁰ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.64

²⁸¹ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.68

The Government believes reducing intermediation costs and removing barriers to direct engagement for individuals wishing to hold shares electronically is a desirable policy objective. It will however be necessary to address this recommendation in the context of policy proposals relating to central securities depositories and securities law in the EU. This will include consideration of future arrangements for how investors can hold shares in a way that increases shareholder transparency and facilitates them exercising their shareholder rights, under the requirements set out in any final EU legislation.²⁸²

²⁸² Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.70

9 Annex C: Professor Kay's Good Practice Statements

Good Practice Statement for Asset Managers

Asset Managers should...

1. Recognise that they are in a position of trust managing client money and should act at all times in the best long-term interests of their clients, informing them of possible conflicts of interest and avoiding these wherever possible.
2. Operate within a culture of open dialogue with their clients – building an agreed understanding of investment objectives and risks, which is informed by their investment expertise.
3. Provide information to clients, including information on investment performance, in a way which is clear, timely, useable and relevant to the long-term creation of value in the investee companies, and therefore to clients' investment objectives.
4. Disclose fully all costs that fall on investors in a way that investors can understand.
5. Ensure that income generated from lending securities is rebated in full to the fund, with any related costs disclosed separately.
6. Adhere to the investment strategy agreed with clients.
7. Prioritise medium to long-term value creation and absolute returns rather than short-term returns from market movements when making investment decisions.
8. Build an ongoing relationship of stewardship with the companies in which they invest to help improve long-term performance – recognising that engagement goes beyond merely voting.
9. Make investment decisions based on judgments about long-term company performance, informed by an understanding of company strategy and a range of information relevant to the specific company, and avoiding reliance on single measures of performance.
10. Be prepared to act collectively to improve the performance of their investee companies.
11. Be paid in line with the interests and timescales of their clients. Specifically remuneration should not be related to short-term performance of the investment fund or the performance of the asset management firm. Instead, a long-term performance incentive should be provided in the form of an interest in the fund

(directly or via the firm) to be held until the manager is no longer responsible for that fund).²⁸³

Good Practice Statement for Asset Holders

Asset Holders should...

1. Recognise that they are in a position of trust managing client money and should act at all times in the best long-term interests of their clients, informing them of possible conflicts of interest and avoiding these wherever possible.
2. Operate within a culture of open dialogue with beneficiaries – building an agreed understanding of investment objectives and risks.
3. Provide information to beneficiaries, including information on investment performance, in a way which is clear, timely, useable and relevant to clients' investment objectives.
4. Be proactive in setting mandates for asset managers based on open dialogue about agreed investment objectives.
5. Set mandates which focus managers on achieving absolute returns in line with beneficiaries' long-term investment objectives, rather than short-term relative performance benchmarks.
6. Recognise that diversification is the result of diversity of investment styles.
7. Review performance no more frequently than is necessary, and with reference to long-term absolute performance.
8. Encourage and empower asset managers to engage with investee companies as a means of improving company performance to deliver investment returns.²⁸⁴

Good Practice Statement for Company Directors

Company Directors should...

1. Understand their duties as directors under the Companies Act 2006, and in particular acknowledge the relevance of considering long-term factors, including relevant environmental, social and governance issues, and the reputation of the company for high standards of business conduct, in fulfilling their duty to promote the success of the company.
2. Acknowledge that long-term value creation in the interests of shareholders is best served by strategies which focus on investing appropriately to deliver sustainable performance rather than treating the business as a portfolio of financial interests.

283 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 53

284 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 56

3. Act to ensure that the intermediation costs associated with a publicly traded company are kept to a minimum.
4. Ensure that corporate reporting is focused on forward looking strategy.
5. Facilitate engagement with shareholders, and in particular institutional shareholders such as asset managers and asset holders, based on open and ongoing dialogue about their long-term concerns and investment objectives.
6. Provide information, in the context of corporate reporting and ongoing shareholder engagement, which supports shareholders' understanding of company strategy and likely long-term creation of value, including by agreeing a range of performance metrics relevant to the company.
7. Communicate information to shareholders which aids understanding of the future prospects of the company, even if this means going beyond (but not against) the strict requirements of accounting standards, for example on market valuations.
8. Not allow expectations of market reaction to particular short-term performance metrics to significantly influence company strategy.
9. Refrain from publishing or highlighting inappropriate metrics which may give a misleading impression of anticipated future company performance.
10. Be paid in a way which incentivises sustainable long-term business performance: long-term performance incentives should be provided in the form of company shares to be held until after the executive has retired from the business.²⁸⁵

Formal Minutes

Tuesday 16 July 2013

Members present:

Mr Adrian Bailey, in the Chair

Mr Brian Binley	Rebecca Harris
Paul Blomfield	Ann McKechin
Mike Crockart	Mr Robin Walker
Caroline Dinénage	Nadhim Zahawi

Draft Report (*The Kay Review of UK Equity Markets and Long-Term Decision Making*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 145 read and agreed to.

Summary and annexes agreed to..

Resolved, That the Report be the Third Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for printing with the Report in addition to that ordered to be reported for publishing on 29 January, 19 March, and 2 July 2013.

[Adjourned till Tuesday 3 September at 10.00 am

Witnesses

Tuesday 5 February 2013

Page

Professor John Kay, Chair of the Review of UK Equity Market and Long-Term Decision Making

Ev 1

Tuesday 14 February 2013

Lord Myners CBE, Former Financial Services Secretary and author of *Institutional Investment in the United Kingdom: A Review*

Ev 15

Tuesday 26 February 2013

Catherine Howarth, Chief Executive Officer, FairPensions, **Christine Berry**, Head of Policy and Research, FairPensions, **Simon Wong**, Visiting Fellow, LSE and Partner, Governance for Owners, and **Dr Paul Woolley**, Head of the Paul Woolley Centre for the Study of Capital Market Dysfunctionalities

Ev 31

Dominic Rossi, Global Chief Investment Officer, Fidelity Worldwide, **Anne Richards**, Global Chief Investment Officer, Aberdeen Asset Management, **Harlan Zimmerman**, Senior Partner, Cevian Capital, and **Roger Gray**, Chief Investment Officer, Universities Superannuation Scheme

Ev 40

Tuesday 5 March 2013

Anita Skipper, Corporate Governance Adviser, Aviva Investors, **Steve Waygood**, Chief Responsible Investment Officer, Aviva Investors, **Neil Woodford**, Head of UK Equities, Invesco Perpetual, and **Chris Hitchen**, Member of Kay Advisory Board Team and Chief Executive, Railpen

Ev 53

Daniel Godfrey, Chief Executive, Investment Management Association, **Guy Sears**, Director, Institutional, Investment Management Association, **Penny Shepherd**, Chief Executive, UK Sustainable Investment and Finance Association, and **Matthew Fell**, Director of Competitive Markets, Confederation of British Industry

Ev 65

Tuesday 26 March 2013

Rt Hon Vince Cable MP, Secretary of State for Business, Innovation and Skills

Ev 74

List of printed written evidence

1	The Government	Ev 85; Ev 170
2	Aberdeen Asset Management plc	Ev 168
3	Albion Ventures LLP	Ev 89
4	Association of General Counsel and Company Secretaries of the FTSE 100	Ev 115
5	Aviva plc	Ev 99; Ev 106
6	BlackRock	Ev 127
7	BT Pension Scheme Management Ltd (BTPSM), Universities Superannuation Scheme (USS) Limited and Railpen Investments (RPMI)	Ev 120
8	Cevian Capital	Ev 160
9	Chartered Institute of Personnel and Development (CIPD)	Ev 137
10	Fidelity Worldwide	Ev 162; Ev 162
11	Financial Reporting Council	Ev 170
12	Philip Goldenberg	Ev 86
13	Investment Management Association	Ev 146
14	National Association of Pension Funds Limited	Ev 122
15	PIRC Analysis of Voting on Director Elections 2009 to 2012	Ev 158
16	Quoted Companies Alliance	Ev 125
17	Russell Investments	Ev 91
18	ShareAction (formerly FairPensions)	Ev 107; Ev 113
19	Standard Chartered Bank	Ev 87
20	Tomorrow's Company	Ev 143
21	UK Shareholders Association	Ev 134; Ev 136
22	UK Sustainable Investment and Finance Association (UKSIF)	Ev 141
23	USS Investment Management Limited	Ev 166
24	Dr Paul Woolley	Ev 163

List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2013–14

First Report	Women in the Workplace	HC 342-I/II/III
Second Report/First Joint Report	Scrutiny of Arms Exports and Arms Control (2013): Scrutiny of the Government's UK Strategic Export Controls Annual Report 2011 published in July 2012, the Government's Quarterly Reports from October 2011 to September 2012, and the Government's policies on arms exports and international arms control issues	HC 205

Session 2012–13

First Report	The Hargreaves Review of Intellectual Property: Where Next?	HC 367-I/II(HC 579)
Second Report/First Joint Report	Scrutiny of Arms Export Controls (2012): UK Strategic Export Controls Annual Report 2010, Quarterly Reports for 2010 and January to September 2011, the Government's review of arms exports to the Middle East and North Africa, and wider arms control issues	HC 419
Third Report	Post Office Network Transformation	HC 84(HC 678)
Fourth Report	Overseas Students and Net Migration	HC 425(Cm 8557)
Fifth Report	Apprenticeships	HC-I/II/III(HC 899)
Sixth Report	The Insolvency Service	HC 675 (HC 1115)
Seventh Report	Too Little, Too Late: Committee's observations on the Government Response to the Report on Overseas Students and Net Migration	HC 1015(Cm 8622)
Eighth Report	Pre-appointment hearing of the Government's preferred candidate for the post of Groceries Code Adjudicator	HC 1011
Ninth Report	Local Enterprise Partnerships	HC 598(HC 585)

Session 2010–12

First Report	The New Local Enterprise Partnerships: An Initial Assessment	HC 434 (HC 809)
Second Report	Sheffield Forgemasters	HC 484 (HC 843)
Third Report	Government Assistance to Industry	HC 561
Fourth Report / First Joint Report	Scrutiny of Arms Export Controls (2011): UK Strategic Export Controls Annual Report 2009, Quarterly Reports for 2010, licensing policy and review of export control legislation	HC 686
Fifth Report	Government Assistance to Industry: Government Response to the Committee's Third Report of Session 2010–11	HC 1038

Sixth Report	Is Kraft working for Cadbury?	HC 871
Seventh Report	Rebalancing the Economy: Trade and Investment	HC 735 (HC 1545)
Eighth Report	Trade and Investment: China	HC 1421 (HC 1568)
Ninth Report	Time to bring on the referee? The Government's proposed Adjudicator for the Groceries Code	HC 1224-I
Tenth Report	Pub Companies	HC 1369-I/II (<i>Cm 8222</i>)
Eleventh Report	Time to bring on the referee? The Government's proposed Adjudicator for the Groceries Code: Government Response to the Committee's Ninth Report of Session 201-12	HC 1546
Twelfth Report	Government reform of Higher Education	HC 885-I/II/III (HC 286)
Thirteenth Report	Pre-Appointment Hearing: Appointment of Director of the Office for Fair Access	HC 1811
Fourteenth Report	Debt Management	HC 1649 (HC 301)
Fifteenth Report	Stamp Prices	HC 1841-I/II

Oral evidence

Taken before the Business, Innovation and Skills Select Committee

on Tuesday 5 February 2013

Members present:

Mr Adrian Bailey (Chair)

Paul Blomfield
Rebecca Harris

Ann McKechin
Robin Walker

Examination of Witness

Witness: **Professor John Kay**, Chair of the Review of UK Equity Market and Long-Term Decision Making, gave evidence.

Q1 Chair: Can I thank you and welcome you, Professor Kay? Could we just start by letting you introduce yourself for voice transcription purposes?

Professor Kay: I am John Kay, author of the review of equity markets and long-term decision making.

Q2 Chair: I will start off with a fairly general question. In your analysis, you basically downgraded the role of equity finance in terms of business capital investment. However, there did seem to be some contradictory evidence from the Quoted Companies Alliance. Could you tell us whether equity markets remain an essential source of capital for new investment in British business? What are your thoughts? Coming from your perspective, and that of the Quoted Companies Alliance, what do you think is the right sort of balance of evidence?

Professor Kay: There are two ways of looking at it. One is to consider what has been raised over the last 20 years or so. We actually find that if we strip out the amounts that were subscribed in the rescue rights issues of British banks—most of it by the Government—then total new equity issuance has been negative, not positive. By that I mean that more shares have been bought back or removed from the market through people buying companies from cash than have been raised in new issues. In that sense, equity markets are not now a source of fundraising.

If I look at it from the other point of view, which is the question of where quoted companies actually get money from, the answer is that they are overwhelmingly now self-financing. If one examines British quoted business as a whole, it makes more cash flow from operations than it currently invests. We know that at the moment British companies, taken as a whole, are sitting on a large pile of cash, and that the vast majority of quoted companies are individually self-financing as well. When quoted companies go outside the company itself to raise new money in the markets, they have largely done it through debt, rather than through equity.

Q3 Chair: Could it be, though, that even though the overall figures indicate a diminishing role for equity finance, it is still, or has been, strategically very important for some companies?

Professor Kay: Rarely, I think. The other side of it, which causes me a lot of concern, was the observation

that successful small and medium-sized companies less and less regard getting public market quotation as a natural part of their development. Another reason for that is that business is less capital intensive than it was. We think of knowledge businesses as being the future, and these businesses may incur operating losses in their startup years, but they do not require huge quantities of physical investment. Equally, the kind of physical investment that we do need in business is now much more fungible than it was. It is property, computers, and that kind of thing, which can be provided through other ways than equity finance. I am not either applauding or deploring this. I am just describing what I think has happened.

Q4 Chair: I understand that. How did this affect your recommendations in the review?

Professor Kay: It took me to saying that “This is how things are, and, actually, I don’t think they are going to change very much.” Equity markets are, in this sense, fundamentally secondary markets. In a way, the tail has come to be much larger than the dog. Therefore, corporate governance and issues around that are not a small part of the way in which equity markets relate to corporate performance. They are actually a very large part of it; in some ways, they are the main thing that we should be looking at. As far as investment and decision making in business is concerned, what equity markets are doing in effect is, they are a way of supervising the investment decisions and the strategic decisions that are made by company management. That is the way we should look at it, and it is the way that I did look at it.

Q5 Chair: Given your position on this—and I think you have touched on this already, but if you could just spell it out—how do you see the role of the equity market in future?

Professor Kay: As things are at the moment, I see it probably playing a diminishing role. We have said that it is not an important source of finance for new business. We have said that it does not seem to be the case that new British companies are coming to market. One of the striking things, if you look down the list of new listings on the London Stock Exchange over the last five to 10 years, is that although it is quite a long list you will not find many ordinary, non-financial British companies on it. This is not the way

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that British business now seems to be growing and developing. There are a lot of reasons for regretting that, but that seems to be the way that things are now. We have put in place measures, partly through regulation and partly through other means, which mean that insurance companies and pension funds have a smaller proportion of their portfolios in equities than they used to. Of course, the pretty disappointing returns that savers have made from equity markets over the last 10 years have not made equity markets look exciting as a vehicle for savers in the way that they did in the 1980s and 1990s. At that time, just buying equities randomly was almost a way of making quite a lot of money.

Q6 Chair: This may perhaps be slightly beyond your terms of reference, but I have an observation arising from what you have just said, and I would be interested in your view on it. The larger companies are not turning to the equity market: they retain savings, and so on and so forth. Smaller businesses are finding it incredibly difficult to access capital from the banking service. Would you say that there is a structural failure in the market?

Professor Kay: Yes, I do. Our capital markets are not working well, in terms of their primary job of getting capital to businesses that need it. The critical requirement for small and medium-sized companies is to cover the operating losses of developing a business position, rather than, as I described, to buy plants and machinery and build factories, as was traditionally the case in the past. Banks never provided that much finance of that kind anyway, but we all know how little finance is now being provided for small and medium-sized companies.

As you say, this was not part of the terms of my review, but it is something about which I am very concerned, and plan to write about in what I am currently writing in terms of the financial services industry. It is one of the biggest problems we have in relation to the functioning of UK capital markets. What I would like to see would be the development of new specialist institutions that were more oriented to the provision of equity or near equity capital than the banks traditionally have been. They would perhaps be a bit like the venture capital industry used to be, before it rather lost its way and became private equity, and much more interested in buyouts of established businesses.

Chair: I think it is likely that the Committee would love to pursue this line of questioning.

Professor Kay: Whether it is today is another matter.

Chair: It perhaps takes us rather beyond our remit. However, if you are writing about it, it is certainly quite possible that we will be doing a future inquiry into this, so we will invite you to expand further on that.

Professor Kay: I would be happy to come back, I am sure.

Q7 Chair: In the meantime, I will watch the outcome of your deliberations with some interest. I would now like to move onto the international context and the market. Your analysis found that the owners of more than 40% of UK shares are based outside of the UK.

How do you think that that has affected corporate governance and stewardship of UK companies?

Professor Kay: We have brought in a group of people who, for various reasons, are rather more reluctant than UK institutions used to be to involve themselves in the governance and strategy of UK companies. There is a term that I would rather not use in all of this, which is “share ownership,” because, as I talk about in the report, exactly what we mean by “share ownership” is quite a difficult question. I have described critical players in this today as being “asset managers”, and so our equity market is now dominated by large asset managers. Some of these are American firms like Fidelity, Capital, BlackRock and Vanguard. Some of them are British firms like Legal & General and M&G. Those are the biggest beasts in the equity market scene.

A lot of the funds that they manage are ultimately funds that originate outside of the UK. Many, although not all, of the funds that they are managing—whether they are American or British—are funds that originate within the UK. The picture is more complicated than the ONS statistics on share ownership, for instance, suggest. The basic element in this is that there are more foreign beneficial holders of UK equities, and there are more foreign-based asset managers in the market, than there were 20 years ago. There is also an element of sovereign wealth fund involvement in this, of which Norway and Singapore are the largest.

Many of these people are more reluctant to get involved in governance and strategy of UK companies than British institutions used to be. This is perhaps because that is not the way that Americans tend to operate; historically, Americans are more reluctant to work together than UK institutions. As with the sovereign wealth funds, they are a bit scared of getting involved in UK business. That is what led me to write that one of the things I would like to do would be for the British Government to say that, “For the people we are talking about, we would welcome greater involvement and collective involvement in British business on their part.”

Q8 Chair: You have anticipated my next question.

Professor Kay: Sorry.

Chair: That is fine. The question was to be whether this is good or bad. I would gather that, from your perspective, you think that greater involvement of such funds in British business would actually be a positive, rather than a negative, influence.

Professor Kay: I think that it would, if it is the right kind of involvement. A lot of people talked about the merits of greater shareholder involvement. One needs to be a little bit cautious about that, because we have had rather negative shareholder involvement in many ways. I talked, for example, in the report about some of the signature examples of things going badly wrong in large British companies: the disappearance, essentially, of ICI and GEC, for example. The truth is that the breakups that led to the ultimate collapse and disappearance of these companies were encouraged by shareholders. Indeed, if these companies had not been as oriented towards equity markets as they were, it is unlikely that these developments would have

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occurred. The kind of shareholder involvement that is about making shortterm gains from restructuring and refinancing, rather than promoting the longterm operating capabilities of the business, is negative, not positive. That is why I think that we have to look, at the same time, at the style of asset management that asset managers deploy.

Q9 Chair: You state that the “general direction of our recommendations to asset holders and asset managers should, overall, be helpful to smaller companies”. Could you elaborate on this?

Professor Kay: What we would like to see is longerterm, more concentrated portfolios by asset managers who take a strong interest in the companies in which they invest. We were talking a few moments ago about small and mediumsized businesses, and their funding problems. In my view, that is exactly the kind of funding that the typical small and mediumsized business is in need of, and is the kind of funding that is not currently very well provided through public markets in many cases.

Q10 Paul Blomfield: I wonder if we could reflect a little on where we go now. In drawing your report to a conclusion, you talk about the challenge ahead and say that the task will be “long and difficult. But it is time to begin.” Who do you think should be picking up the ball, and how well do you think they are doing it?

Professor Kay: There are a whole range of people who should be picking up the ball. Government should clearly be picking up the ball, but there are limitations to what the Government can do. There are two very fundamental ways in which Government can contribute. One is that Government, and you as politicians, have a huge effect in setting the tone of public debate. If we are trying to change the way that people think about markets and the relationship between markets and companies, the way in which we have a public dialogue about that is terribly important. The second—and this is described a bit in the report—is that a lot of our regulation of financial markets has gone quite badly wrong. Let me make clear that I am not against financial market regulation. However, I think we have gone far too far down the specification of detailed rules. We have also tended to view financial markets through the eyes of people in financial markets. There is something extraordinarily selfreferential about both the ways in which people in public markets talk and the ways in which we regulate them. We need to reverse that, and say that markets are for users and should be judged by how well they serve users, not by criteria that are essentially generated by the market itself. That, over the long run, is a big shift. At the moment, if anything, we are going in the wrong direction, rather than the right one, in relation to that issue.

Chair: The purpose of this inquiry is to develop that process.

Q11 Paul Blomfield: Giving that responsibility to Government, and recognising its limitations, how well do you feel that the Government have responded to the challenge that you have set?

Professor Kay: It is hard to say at this point. The tone of the Government response, in relation to the two issues that I have just described, was more positive than I had anticipated. I was fearful—and am still fearful—of more push-back from established, vested interests in the financial services industry.

Q12 Paul Blomfield: What about the response from other players?

Professor Kay: The response from asset managers and investment managers has been mixed, but, in the main, pretty positive. I got a strong sense during the work on the review—and it has been confirmed afterwards—that a high proportion of the asset management community would actually like to go down the directions that we are describing. They feel inhibited in doing it by the demands of their customers and by the whole regulatory and market environment in which they are operating. That is why we have to go about making a whole set of piecemeal changes—in tone and in regulation—to try and shift things in the directions that we want to go.

Q13 Paul Blomfield: As a different reflection on your report, you provided a fairly fundamental critique of markets. In response to the Chair earlier you talked about structural failure, or concurred with that view. In that context, there has been some criticism that the report is fairly timid; one commentator said that it whets the appetite for a further report that specifies more of what might be done. How do you respond to that?

Professor Kay: I can see a sense in which that is right, if one is talking about a 20year process of change and reform. The kinds of markets that we have today are the product of a long history. One can see the changes in the 1970s and 1980s that set the way for the financial services industry that we now have. If it is a long process, then it is probably right to say that we are starting to push in a different direction and creating a vision of where we would like to be. That is why I welcomed one aspect of the Government’s response, which was to say, “We will look at this issue again, and see whether we are starting to make progress in the right kind of ways”. That is a sensible way to look at it. What I have said explains, in a way, why we did not do what a number of people would have liked us to do, which would be to set out a raft of detailed regulatory changes and recommendations. I really do not think that would have been helpful in setting the kind of change in tone and direction that I would be seeking.

Q14 Paul Blomfield: You make a strong critique in your report of the limitations of regulation, so I understand where you are coming from. However, one commentator in the FT said that, of your 17 recommendations, only four could really be described as substantial. In the comments you just made a moment ago, you seemed to suggest that you felt you could have gone further. Is that fair?

Professor Kay: Yes. Let me take a radical example: we are in a bit of a mess about insider trading rules. That is a subject where we have not quite thought about what we are doing, and is a classic case in

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which we are tending to view the issue through the eyes of market participants, rather than the ultimate users of markets. I could have said more about that, but I do not think that either financial market opinion or public opinion is yet ready to rethink the way in which we view these kind of issues. We have to move step by step.

Q15 Paul Blomfield: What would you see as future steps? Taking that one example, if public opinion was right, what else would you like to see?

Professor Kay: If one elaborates on that example, what we do at the moment is that we conflate together the kind of fraud involving a guy sitting in a boardroom, and ringing up his hedge fund friend to tell him what to buy and sell when he comes out of the boardroom—these kinds of people ought to be in prison, and we ought to be focusing on how we get tougher enforcement action so that we can get people who do these kinds of things behind bars where they ought to be—with a raft of regulatory and compliance issues that we have, which I think is a different matter. These are the issues that regulate the kinds of interactions that asset managers can have with the companies in which we invest. We are, in effect, saying at the moment that we really want asset managers to engage more forcefully with the companies in which they invest, but if they do, and gain any informational advantage, they may not trade on it. There is a paradox there. I do not believe it is either possible or desirable to say that we will have markets in which everyone is trading on the basis of uniform information.

Q16 Chair: Before I move on to Ann McKechin, could I just put it to you that you have outlined the problems, you have not made that many robust recommendations, but in your evidence to us today—and I hope I am summarising it fairly—you say that too often Government sees regulation through the eyes of the industry? Surely part of your role was to provide the Government with a counterargument that it could use as a basis for introducing a greater degree of intervention. There does seem to be a lacking in your recommendations of the kind of detail that would enable them to do so. How would you respond to that?

Professor Kay: I see what you are saying. First of all, I do not want more regulation. I really want less, in fact, because we have gone down what I sometimes think is a Soviet Union-type road of introducing regulations and, when they do not work very well, making them more elaborate. We then go on, getting more and more frustrated at the fact that they do not work very well. In a way, I would like to see less regulation of financial services, rather than more.

However, what we ought to be aiming at are things that are the products of different kinds of behaviour. For example—and this is a very important one—a lot of the damage is being done by the way in which asset holders and retail savers are judging, and are being encouraged to judge, fund managers and asset managers on the basis of their very short-term performance. Everyone is going through the business of getting quarterly performance reporting, sometimes more often than that, and having the kind of

discussions in which people say, “Why were you 1% behind the benchmark in the last three months?” and so on. I do not think I can introduce regulations that would stop people doing that. Just try and frame the regulation; you cannot do it. Indeed, there is an almost human tendency to try to look at performance terribly often. I know that, now I can press a button on my computer and get the value of my share portfolio at any moment of any day, I quite often do that, even though I know that it is not giving me any useful information.

I do not think we can regulate people to do that. However, what we can do is say to people that it is not good practice, and that hauling your fund manager over the coals every three months and asking why they underperformed last week is not you doing your job conscientiously. It is bad practice. It is not in the long-term interest of your beneficiaries to have that kind of inquiry, because it leads to fund manager behaviour that is short-term, inappropriate, and stimulates them to look at markets and the performance of markets, rather than the underlying performance of companies. That is why I thought that the right way of doing that is to try to tell people what good practice is, so that they can say to their asset managers—as I hope they ultimately would—“Here is some money. Come back after a period of years, and tell me how you have performed with it, because I cannot judge you except over that period of years.” That is not negligent. It is what people ought to be doing.

Q17 Chair: It sounds a bit like the financial equivalent of motherhood and apple pie. Telling people what good practice is, and so on, is very different from actually getting an industry that, by and large, does not seem to put the adoption of good practice at the top of its agenda to do so. Surely there must be some means by which the Government could exercise a monitoring role that would not need a whole raft of detailed regulation.

Professor Kay: Let us look at the example of what has happened in this area, by putting more responsibility on pension fund trustees to monitor the performance of their asset managers and their underlying companies. We have done two things. One is that we have created this market for investment consultants, who are themselves the source of quite a lot of this short-termist behaviour, because they are typically making recommendations to trustees based on recent performance histories, rather than the future approach and strategy of the manager. In addition, we have encouraged trustees to think that they have to be going through this regular routine of performance management. By saying we are monitoring the performance of pension fund trustees more carefully and imposing more obligations on them, which sounds as if it is moving in the right direction, we have in fact done the opposite.

If we want to establish trust relationships as the basis of financial services—and I believe we do—we cannot regulate trust relationships very easily. We need to set up structures and environments in which people can develop them and in which they are encouraged to develop them, rather than the one we have at the

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moment in which people are going through large amounts of compliance-based form-filling and box-ticking.

Q18 Chair: Surely that is because the compliance criteria are wrong. If those were altered, then that could surely change.

Professor Kay: This is where I come back to wanting to set out these generalised statements of good practice. I do not see how I can enforce these. What we have ended up in large part doing—in the corporate governance sphere, for example—is that we have set out what everyone in the corporate sector calls “box-ticking”, in which people are devoting lots of time to worrying about how long non-executive directors have been on the board. These things are not trivial, but they are not much to do with what has really gone wrong in those British companies where things have really gone wrong. GEC did not blow up because it did not have the right lengths of service or experience of non-executive directors. It blew up because of very fundamental misconceptions about the relationship between financial markets and business.

Q19 Chair: Can I just pick up one point that you made, in terms of directors’ remuneration and incentives? I will quote you: “Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business”. I understand what you are trying to say there, but could that not be contradictory, insofar as it might provide an incentive for a higher turnover of directors who would basically take their cash and run when it suited them?

Professor Kay: That is possible. I do not think it would happen very much. Back in this area—as in the area that we have just been talking about—what we want is people running large companies who derive their main satisfaction from their sense of how they have built the company over a period of years. That is what British managers traditionally did, before we started an elaborate and counter-productive process of supposedly aligning their interests with those of shareholders through these complicated bonus and incentive schemes. The people who built the great British businesses of the past—the ICIs, the Shells, the Unilevers and so on—were motivated by the thought that they were building great businesses, and they were. These people did not really think about the share price much. I would like to get back to managers having much more of that kind of approach and attitude.

Q20 Mr Walker: On that point, and on the point about management incentives supposedly aligning with shareholders, do you think that change in culture has made managers of businesses more inclined to sell and take a profit when they can?

Professor Kay: It has certainly made them much more financially inclined, interested in M-and-A-type strategies and restructurings, and a whole variety of issues that are not very closely related to the underlying competitive strengths of the business.

Q21 Ann McKechin: Good morning, Professor Kay. I wonder if you could perhaps give me your opinion of whether there is any added value in having a non-enforceable stewardship code, which is what we currently have?

Professor Kay: Yes, I think there is. We can do a lot to tell people what we regard as good behaviour and put pressure on them to do it, without actually pushing that into formal regulations. There are two disadvantages of framing these things in terms of formal regulations. One is that they are inflexible—not all of these regulations will be applicable to all situations and all companies. The other is that people will be inclined to believe that, so long as they have complied in a formal sense, then they have done their job.

We have seen a lot of examples in the financial services industry of regulation that has worked badly in these respects. The worst example is the capital requirements that we imposed—and, indeed, are now strengthening—on banks. That had essentially the effects I have described: people believed that, so long as they formally complied with the capital requirements, they were managing their risk properly. We know that, in fact, they were not. It also meant that people devised instruments that, in effect, got around the intended effect of the capital requirements. These things encourage formal compliance, rather than substantive compliance.

Q22 Ann McKechin: Some of the evidence given to our Committee—for example, from Aviva—talked about a free-rider problem. They said that good stewardship is a public good, and therefore that if you have one set of asset managers who exercise the code in the right spirit, then basically other asset managers can simply piggyback on that and do not have to bother. In that sense, is there not then a greater need for some form of baseline, and there being consequences for not complying with this baseline? Otherwise, what is the incentive for companies as a whole to improve?

Professor Kay: The freerider problem concerned me quite a lot, and it is discussed at length. That is, in part, why I wanted to introduce measures that made it easier for people to act collectively. In terms of baseline involvement, there is something to be said for that, but, again, it is quite difficult to enforce a low baseline meaningfully. We want asset managers to engage more forcefully and effectively with the companies in which they invest. It is really quite difficult to define what we mean by engagement of a constructive kind.

Q23 Ann McKechin: Do you think the Government should rewrite the code? You have mentioned the fact that you think that the code should be more strategic in its purpose. To what degree do you think Government should be engaged in trying to set that?

Professor Kay: Yes, I do, and that was one of the things I was trying to encourage through statements of good practice. If the industries do not develop these kinds of concepts of good practice, I would like Government to intervene and try to do it for them. However, to me, that is a second best, because what

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we are really trying to do is to influence people to start changing the way in which they behave. The best way to do that is to take advantage of the fact that most of them want to do it. You talked about Aviva. Most fund managers would actually like to move towards the kind of regime that we are describing. It is not because they are recalcitrant; it is because the structure of the environment in which they are operating does not encourage that kind of behaviour. That is why we have to make all of these moves in changing the culture in a way that will bring about the kind of behaviours that we want.

Q24 Ann McKechin: You have mentioned the fact that many asset managers would want to have greater involvement in management of the company. However, surely part of the code should be designed for the general public and savers so that they actually know what it means, and what they can and should expect from the people who are responsible for their savings. FairPensions have indicated that there is really a need for a clearer definition of stewardship. You have mentioned that defining parts of the Code is quite difficult in some ways, but would you agree that greater clarity might be of assistance?

Professor Kay: Yes, I do. I think that the good practice, the stewardship code, and so on, are all things that we would want to evolve over time. That, in a sense, is another reason for not making it too rigid and too inflexible. We want it to be an evolving and developing process.

Q25 Ann McKechin: If I could turn now to the good practice statements, which you have also mentioned in your report, they said that they should prompt market participants to consider their current practice, but will not have the force of regulation or formal guidance. If that is the case, who will be responsible for monitoring the compliance between the asset managers, the asset holders, and the company directors?

Professor Kay: Because they are good practice, I do not think that there is an issue of formal compliance. This is what we want people to do, and we are saying that many people want to do it. However, it is almost impossible to define the kind of engagement we want in terms of formal rules. It is almost impossible to define the kind of longtermist attitude that we want from company directors in terms of formal rules. If managers of large German companies typically have more longterm outlooks than managers of British companies, for example—and they do—it is not because there are different duties in German law to the ones in British law, or different regulations in the two countries. It is essentially because the structure of share ownership in Germany, and the attitudes of many of the large holders of stakes in German companies, are different from the equivalents in Britain. What brings about the difference is not a different regulatory structure or different company law, but a different set of attitudes to how businesses should develop. That is what we need to be focusing on.

Q26 Ann McKechin: We could say this about any business relationship, but, at the end of the day, what happens in the City has an impact on the savings, pensions and economic prosperity of every citizen of this country. Would you not reflect that there needs to be a degree of transparency? If somebody says, “We have a practice statement, and we believe that the outcomes will be X—this will be improved, and there will be some way in which we can give certain degrees of certainty about what we are aiming for, and we will report back to our shareholders or whoever on a regular basis about how we are achieving those outcomes in line with our good practice statement,” then people can see a direct correlation. At the end of the day, this just seems to be a whole other set of words that somebody stores carefully in the shelf and brings out from time to time to say, “We’ve got a good practice statement.” People want to find a way in which they can actually hold people to account for the way in which they are dealing with their money. This is what this is fundamentally about.

Professor Kay: That is right. However, we should then ask how, as savers, we are collectively going to do it. There are two things that we can do. One is, as savers, to place our money with people who adopt the right kind of practices in dealing with that money. That is both looking at what they say they do, and observing whether they actually do it. Secondly, we can develop intermediaries to do that. I think that, at the moment, intermediaries are in the main not being terribly helpful in bringing about the kind of objectives we want. Intermediaries are playing the game of being obsessed with shortterm relative performance rankings. One of the positive developments in this area is the creation of NEST, and I think that people who bring to the industry and to business the kind of attitude that NEST has are capable of being more effective representatives of genuine shareholder interests than we have had up until now.

Q27 Ann McKechin: If people continue to ignore voluntary statements, how could the implementation of policing be firmed up to ensure that they abided by them? You have mentioned that you are not keen on simply having stark Government regulation, but surely the stock exchanges and other professional bodies have a part to play in terms of their own rules and regulations?

Professor Kay: We are not talking about the rules and regulations of the stock exchange very much. We are largely talking about the people whom I see as being key to this process, who are asset managers, and developing different kinds of relationships between asset managers and the savers or the representatives of the savers—who are the ultimate beneficiaries—and companies. You will notice that the way I am describing it is a way that downplays the role of the stock exchange and public markets. That is quite intentional. What I would like to do—and this is fundamentally what is underlying the whole direction of the recommendations—is to try to move towards a world in which financial intermediation is based much more on trust relationships, and much less on transactions and trading, than has been true in the past.

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We will only be able to develop a structure that gets the capital that British business needs, and the returns that savers and all of us need to pay our pensions from, if we do that.

Q28 Ann McKechin: What is the push towards that? We say this is what we would like to happen. If it does not happen, what do you think we should then try to do?

Professor Kay: The biggest push to it would be if we—both as individual savers and as people like pension fund trustees who are placing funds with asset managers—began saying, “We are looking for longterm, strong, absolute returns from the funds that you invest, and are not very interested in your performance relative to other people.”

Q29 Ann McKechin: The pension fund managers are the key part, because the ability of individual shareholders is probably pretty limited.

Professor Kay: Yes, but the expectations of individual shareholders affect the attitudes of the asset managers and everyone else. At the moment, asset managers are very much concentrating on outperformance, relative to other asset managers. That outperformance is typically over quite short periods. That is the largest thing we need to fight against. We need to educate savers not to respond to advertisements that say, “Our fund beat 90% of the others over the last six months.” We need to enable trustees to feel that, not only are they not required to monitor the performance of their asset managers every three months, but that they are actually not serving their members very well if they do so. We need to tell pension fund trustees that the real approach they ought to be taking is finding managers whom they trust and in whose strategies they have confidence. We also need to be saying to asset managers, “This is what we think is good practice as an asset manager, and we are not only going to stop putting obstacles in the way of your constructive engagement with companies, but we are actually going to facilitate it.” There is a whole set of piecemeal changes. Some of them are regulations, but most of them are the attitudes that we need in order to get closer to where we want to be.

Q30 Chair: Can I just come on to investors’ forums, which is a concept that has been accepted by the Government. How do you think that the collective engagement of investors can bring about an alignment of the objectives of shareholders, investors, and business?

Professor Kay: This is what was just described in the last exchange—trying to offset what is described as the freerider problem. If by engagement you improve the performance of a company, but you own 3% of the company, you get 3% of the benefit from what it is you do. The more opportunity there is for people who collectively own 30%, 40% or 50% of the company to act together, the more offset we have against that particular freerider issue.

Q31 Chair: Some evidence that we have received actually challenges this, on the basis that it would “weaken the strength of the shareholder system,

namely, that shareholders vote and act as individuals.” How would you respond to that challenge?

Professor Kay: That is a good example of the issue, which I have described, of viewing markets through the eyes of market participants, rather than the interests of ultimate users. It is in the interests of everyone—savers taken as a whole and companies taken as a whole—that we should do as much as we can to encourage the better performance of British business.

Q32 Chair: Would it be fair to say that that view is based on a myth that shareholders do actually vote and act as individuals?

Professor Kay: They certainly do not vote and act as individuals, to some degree. Amongst the asset managers who control large voting blocks, there is some tendency for them to still act as individuals. It is not shareholders acting as individuals, but it is large institutions acting independently.

Q33 Chair: Consistent with what you said before, and looking at it through the eyes of the financial institutions, the pensions community has told us that this recommendation is not necessary, because “a significant amount of collaboration already takes place amongst UK investors” that is “not always visible.” What consultation did you have with investors, and what was the evidence that led you to come to these conclusions?

Professor Kay: I talked a great deal about this to large asset managers. As I described earlier, I think it is the case that there is a degree of coordination and consultation between Britishbased institutions. I described my experience, which was that Americanbased firms were more reluctant to be involved in this process than Britishbased firms, and their role in the process is now much larger than it was. People talk to me almost endlessly about concert party rules. Although the Takeover Panel kept telling us that this was not, in fact, an obstacle to collective action, it was perceived as one by many of these firms. The sovereign wealth funds, whom I mentioned, keep their heads down, in the main. It is certainly true that there was more collective action amongst British institutions 20 years ago than there is now, and that is primarily because British institutions were a larger part of the total market 20 years ago than they are now.

Q34 Chair: As I said before, the recommendation has been accepted by the Government. However, the quote is that the Government would “like to see further progress across the investment industry”. Who have you recommended should monitor progress in this area, and what do you think is the reason for the delay?

Professor Kay: Monitoring the process, and monitoring progress on most of the recommendations here, is very much a matter for Government. That is who should be monitoring this. I am not myself party to the discussions about setting up such a forum. That is not my job.

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Q35 Chair: We will no doubt be talking to Ministers about this at some time. FairPensions argues that, to shift incentives for market players, some kind of external force is necessary. We do not seem to be getting very far at the moment. There is buckpassing. What do you think this external force should be? Do you think it might be applied to either the Government or the regulator?

Professor Kay: The application of external force is clearly a matter for Government. We have talked earlier about the two ways in which that kind of Government external force can be applied. One is through Government setting the tone and terms of debate, and that is very important. The whole set of issues around saying that the purpose of finance is not to serve finance, but rather to serve savers and business, represents a big change from the tone of what Government has been saying about the financial system for quite some time.

The other is that we need to get regulation right. We are making some progress in that; there are signs that the new regime will be more user-focused than the old FSA structure was. However, we have an awfully long way to move in that direction, and to emphasise that the critical feature of our regulation should be what it does for companies and savers, not what it does for people in the market. In Europe, which is the driver of quite a lot of our financial regulation now, we are very far from being in the kind of position that I have been describing.

Q36 Chair: I am a layperson. I have never been involved in this particular industry at all. However, I think that my perspective is probably shared by the public at large, which is that just a change in tone is not likely to realise a change in habit, policy, and so on. Surely there needs to be something that will exercise more influence on the industry?

Professor Kay: I understand your desire, which, in large part, I share. If I could find regulatory provisions that would do the kind of job that we are describing, I would support them. I find it very difficult to see what these regulatory provisions are going to be. Indeed, the starting point should be withdrawing some of the regulatory provisions that are going in the opposite direction. We have, at the moment, a market abuse directive. Think about that phrase for a moment. It is not market abuse that we should be concerned with; it is customer abuse, and a customer abuse directive would look very different from a market abuse directive. Our concern is not with manipulating the market, except insofar as manipulating the market creates a worse deal for companies and savers. That is the kind of preoccupation we need.

I was quite struck, hearing an interview with the chief executive of one of the big execution-only share dealers acting for retail customers in the markets. He was asked what effect MiFID—the Markets in Financial Instruments Directive—had had on his customers. There was a pregnant pause for a moment, at the end of which he said, “I can’t think of any.” We are proliferating this kind of regulation, which essentially entrenches the existing structure of the industry. That is why I want to be focusing on the interests of users and customers.

Chair: We will look at that in greater detail during the course of the inquiry.

Q37 Rebecca Harris: You recommend that companies should consult their major longterm investors over major board appointments. I was wondering if you could just clarify for the Committee what you mean by a “major investor”, and also a “longterm investor”?

Professor Kay: We are really talking about, in general, the six to 10 large asset managers who are now speaking for a very large proportion of UK equities. Obviously, since they do not all hold the same proportions, they would be different people in relation to different companies. If we move to a world—which is the world I would like to see—in which there was more differentiation of asset manager portfolios than there is at the moment, so that you were not always finding the same six or 10 at the top of the shareholder register of companies, you would have much more specialist relations between companies and their investors. In that world, it would be natural and part of the ongoing engagement with the company that the company should consult the investor. That is what I have in mind. Obviously, companies cannot realistically consult shareholders at large. We have the essentially formal reelection at the annual general meetings that are part of current practice, but that is a formality, as we all know.

Q38 Rebecca Harris: Can you also define for us what you would consider to be a “major board appointment”?

Professor Kay: I think that, by “major board appointment”, I probably mean any board appointment. We were thinking, in part, that for smaller companies it would probably be primarily about the chairman and chief executive.

Q39 Rebecca Harris: So it would depend on the company, rather than the board. How would you recommend that companies should balance consulting with their shareholders with the difficulty of confidentiality around information attached to the appointment?

Professor Kay: This goes back to the regulatory front. I would like to be much more relaxed about all of this. I am not sure that the raft of regulations that we have designed to control the flow of information to investors is actually serving the interests of either investors or companies. It is in large part there to protect the interests of shortterm traders, so I am not that bothered about confidentiality. The sense in which I have to be bothered about the confidentiality front is that, at the moment, there are asset managers who will say that they are reluctant to be consulted by the companies on serious issues because that may make them insiders who are unable to deal in the company’s stock. That goes back to the issue that I am not really sure that the current, nearobsessive emphasis on uniformity of information is serving useful, desirable purposes.

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Q40 Rebecca Harris: Did you go as far as considering that longterm substantial shareholders should have direct board representation?

Professor Kay: That is a matter between the investor and the company. At the moment, many asset managers would say that they did not really have the expertise to do this. I would hope, increasingly, that they would. That is probably more a matter for smaller companies, where the company has more difficulty finding nonexecutive directors with wide experience, than it is for larger companies. A particular asset manager would ideally have quite a strong relationship with such a company, if he decided to invest in one.

Q41 Rebecca Harris: You recommended that BIS should take a rather more sceptical attitude about the claimed benefits of foreign takeovers. I wondered how much we have to be careful there, given that many UK companies are also active in acquiring foreign businesses. I wondered if you could comment on that.

Professor Kay: One of my views on this is that we have too much merger and acquisition activity of all kinds, whether inward or outward. I understand the concerns about the inward takeover—the Cadbury issue—but in terms of terrible takeovers that have damaged British business in the last 20 years, RBS taking over ABN AMRO or GEC taking over rather curious US telecoms companies were not great successes. The damage done to British business by M and A activity is not just a matter of good British companies being taken over, although that is a problem; it is also British companies who, when you talk to them about strategy—and this is true when you talk to a lot of people in the City about what they mean by “strategies”—believe it means, “What businesses are you going to buy and sell?” That is not what I mean by strategy. It may sometimes be the right thing to do, but strategy is really about building up capabilities and operating businesses. That is the focus that I would like to see.

Q42 Rebecca Harris: So therefore, future success in this area for you would be fewer mergers and acquisitions, or fewer that fail?

Professor Kay: I think we can all vote for fewer that fail. Since, to be honest, none of us know which are going to be successful or unsuccessful, I would like for there to just be fewer. One of the things that one is bound to think about is whether we should have more powers for the Secretary of State, or the Competition Commission or its successors, to block mergers. I am stuck there with the difficulty that either the Secretary of State or the company itself has in knowing whether a merger will succeed or not, in the long run.

Q43 Rebecca Harris: How does that work? As we have said, we do not know which are going to succeed and which are going to fail.

Professor Kay: I know that there are too many, but I do not know which ones are the “too many”. I would like to just have fewer. The real thing that we are trying to achieve is what I described earlier: persuading the senior executives that their job is to

develop the capabilities of underlying businesses. They are not what I have described as “meta fund managers”, who are juggling portfolios of businesses, rather in the way that fund managers are juggling portfolio stocks. That, frankly, is more or less how quite a lot of people have seen the chief executive role over the last decade or two.

Q44 Rebecca Harris: It is kind of a cultural change, basically, isn't it?

Professor Kay: Yes, and it is another good example of the kind of thing where it is very difficult to see how it could be addressed through regulation, but where we can do an awful lot by tone.

Q45 Rebecca Harris: There have been comments about the Takeover Panel; there have some criticisms, saying that it is effectively a cartel of the investment banks with no statutory basis, which focuses solely and explicitly on price. What kind of role do you see for the Takeover Panel in implementing your recommendations, and how would it perhaps need to change?

Professor Kay: I am not sure that I want the Takeover Panel to be doing very different things from what it is doing now. When there is a contested bid, there is a job to be done in insuring against malpractice of various kinds. That is what the Takeover Panel has done over the decades it has been in existence, and it has done reasonably well, overall. However, it is a terribly limited function, and of course it is not its function—nor should it be—to say whether a bid is any good or not. It has been described as a cartel of investment banks. I think that is largely right, although not necessarily derogatory, if it has the narrow role that I am describing. However, there is an interest on the part of investment banks. We have had a relatively modest rate of takeover activity since the crisis of 2007–2008. That is probably a good thing, but I am not sure that it is here forever. There are fashions and cycles in merger and acquisition activity, and I expect that we will have another one some time in the next few years.

Chair: Can I bring in Robin Walker on Cadbury, derivatives, futures and shortselling?

Q46 Mr Walker: Before we move on to that, I just wanted to pick up on a couple of points relating to foreign takeovers in my personal experience. I should probably refer to the register of interests the fact that, prior to coming here, I used to work in financial communications in the City. I actually worked on a number of takeover defences, both hostile and friendly, of UK PLCs. In my experience, when an approach was first made, in every case management set out to continue running the company, to defend the company, and to drive up the value of the company. However, there was then a process in which they drove up the value of the company, showed what a good job they were doing and won shareholders over, and then the shareholders ended up putting pressure on the management to sell at a higher price. In, I think, five out of the six of those types of situations that I worked in, the companies ended up being taken over. It comes back to this thing about the culture change

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of shareholders. Are shareholders just too ready to take cash when it is offered, and what can be done to make them appreciate the longterm value that can be created if they hold on?

Professor Kay: The most constructive thing that we can do is divert attention away from shortterm performance. If you are being judged by your relative performance over a threemonth period, and you are being offered a substantial premium for your shares over what they were selling at three months ago, the pressures to accept are really quite great. It is once you get into the business of looking at the portfolio over three or five years that it starts to be less obviously attractive to accept the kind of bids you describe.

Q47 Mr Walker: One of the problems there—and this comes into the whole CadburyKraft thing and the argument about shortselling and shortterm shareholders—is that not everyone holds their shares for five or six years. You have got the longterm investors, who are there and who form a rump, but often during the course of the takeover you will have more and more shortterm investors—hedge funds—moving in and taking a greater proportion of the register.

Professor Kay: As you know, one of the things that was put to us—and there was quite a lot of discussion about this—was whether shortterm holders of that kind should be disenfranchised in some way in these cases. It seemed to me that one reason for not going down that route was that if you asked, “Where did the arbitrageurs get their shares from?” the answer was, in most cases, “From the long-term holders.” That suggests that the real issue we have to address relates to the longterm holders, rather than to the arbitrageurs.

Q48 Mr Walker: The CadburyKraft situation was described at the time as a disaster for Cadbury and the country by interested parties. Traditionally, only 5% of the stock of Cadbury was held by shortterm owners. At the time of the sale, the figure had risen to 30%. I suppose it comes to that question: why should those short-term holders not have their influence reduced—although not necessarily disenfranchised—in a situation such as that?

Professor Kay: I do not see any harm in that. However, if, as we are saying, that 25% came from these longterm holders taking the higher price in the market, then that is the source of the problem. We would not change the outcome significantly. We might change it a bit, because some of these holders might be more reluctant to be publicly identified with growing their 8% stake, but it would, in a sense, be marginal.

Q49 Mr Walker: Overall, if all your recommendations were adopted by the industry and the Government, do you think there would have been any difference in the outcome of something like the Cadbury takeover attempt?

Professor Kay: We might just start with Government being less relaxed than it historically has been about takeovers in general. If one looks at examples of takeovers that one really does wish in retrospect had

been stopped, the examples would be the Ferrovial bid for BAA in terms of inward takeovers and the RBS bid for ABN AMRO in terms of outward takeovers. Powers already existed to stop these bids; they were just not actually used. In terms of generally reducing the incidence of these, we should just move away from where we have historically been, namely having more or less the most liberal regime in the world in terms of attitudes to takeovers of, or by, British companies.

Q50 Mr Walker: Going back to my previous experience, one of the nonUK situations that I worked on was the defence of Arcelor against Mittal. That was one in which Governments tried to play quite a substantial role in stopping the company getting taken over, but that eventually got effectively brushed aside by shareholder power and by the weight of hedge funds pushing for a deal. I suppose that there are limitations on what Governments can do.

Professor Kay: There are limitations. If we have a policy objective of reducing the pace of takeover activity, which is certainly one that I would like to have—as I said a few moments ago, it has happened of its own accord for the moment, but one might ask how permanent that is going to be—we can gradually ratchet up the degree of hostility to see what level is necessary to get, at least in that sense, a level playing field with other countries. One of the problems that we have is that there is a sense in the investment banking community that Britain is for sale, which is not true in the same way in many other countries.

Q51 Mr Walker: One thing that other countries are looking at, and that was not touched on in great detail in the report, was the impact of derivatives and futures and practices such as shortselling. Do you think that there is anything that we should be looking at in that respect?

Professor Kay: Quite a lot was said to us about shortselling. I came to the view that, while it could be the case that you had good companies that were being destroyed by shortsellers, one could not find examples of that happening, certainly not in Britain. However, one could find cases where bad companies, whose management either did not know or were not telling the truth about how bad the company was, had their company management damaged by shortsellers and were in some cases brought down by them. That kind of shortselling does not seem undesirable to me. It could rise to a degree at which it was undesirable, but I am not sure that we are there yet.

Q52 Mr Walker: That is interesting. You say firstly that shortselling is incompatible with the concept of stewardship, but you then go on to set out your reasons for defending it. How far do you think your recommendation that income from stock lending should be disclosed and rebated to investors would go to address the public distrust and concern about shortselling?

Professor Kay: I do not think it would address the public distrust of shortselling. One can understand the public suspicion of shortselling, because it is not a very nice activity, fundamentally. I think the rebate

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and disclose activity is just a matter of straightforward transparency about what the costs and charges of financial intermediation actually are. What we have at the moment is a situation in which some of these costs are, in effect, being concealed from the beneficiaries. Beneficiaries are potentially being exposed to risks that they may not know about, and the rewards relating to the risks are actually being taken by other people, rather than by the beneficiaries. I do not think that situation is acceptable.

Q53 Mr Walker: Speaking of intermediaries and beneficiaries, I just want to come back to your exchange with Ann earlier, where you were talking about the culture and attitudes of shareholders, and trying to change the culture in order to take a long-term approach. Intermediaries came up. One observation that I would make is that the biggest culture change of all has been in the intermediaries. Even during my relatively brief time in the City, I saw gradual decline of long-term corporate broking relationships, and of corporate broking houses that had based their whole approach on having long-term relationships with their clients. These have been replaced by a much more M and A, investment banking-focused approach. Do you think that there is anything that could be done to change that, and to reverse that direction of travel? From what I can see, that process is very much continuing.

Professor Kay: For me, that absolutely gets to the heart of the issue, that the largest cause of almost all the issues that we are describing has been the replacement in financial intermediation of a relationship-based culture with a transactions and trading-based one. How do we reverse that? To repeat the kind of approach that I have been saying over and over again, firstly it is a matter of tone and culture. We can do a lot to set the tone. The tone has almost been that the relationship-based way of doing business in this sector is a terrible, old-fashioned way of doing things that the benighted Germans are still immersed in, but that we Brits and Americans have got over. Instead, we need to be moving in the opposite direction and confronting the reality, which is that the Germans have actually done pretty well in building great companies for the long term.

There is the tone issue, and then there is the regulatory issue. As I have suggested at several points, regulation has in large part been about making life safer for traders. What we ought to be doing is not making life safer for traders, but rather making life easier for long-term investors. That is a very big change of philosophy.

Q54 Chair: Before I move on to fiduciary duty, could I just go back again to the Cadbury-Kraft situation? In response to Robin's question, you pointed out—quite accurately, I believe—that it was actually the long-term investors in Cadbury that eventually agreed to sell. I cannot remember the exact figure, but the majority of the shareholding certainly would have been composed of long-term investors. However, would it not be true to say that it was the activities of the short-term investors that drove the share price up to a point that the long-term investors were prepared to sell at, and if

those short-term investors had been disenfranchised, that would have been unlikely to happen?

Professor Kay: I am not sure that is right. What drove the price up was how much Kraft was, in the end, willing to pay to get it. I do not see that the role of the hedge funds played a large part in that.

Q55 Chair: So you don't think that was a significant factor in the eventual share price at which it was sold?

Professor Kay: No. I think that the board pushed to the limits of Kraft's willingness to pay.

Q56 Chair: Can I come on to the fiduciary duty issue? What do you consider to be the minimum fiduciary standards that a regulator should enforce?

Professor Kay: The minimum is that anyone who is engaged, either in advice or in discretionary activity of some kind, accepts the obligation to put the client's interests first, ahead of his or her own. The second is that conflicts of interest should be avoided, and should be disclosed where they are not avoided. There should be a requirement not to profit as a result of the existence of the conflict of interest. I think that these are the minimum standards, and in my view, I do not want to distinguish between wholesale and retail markets in the application of these.

Q57 Chair: That is an interesting reply. I was under the impression that you had highlighted loyalty and prudence as being core fiduciary duties, but you have not actually mentioned those, at least not directly. Why is that?

Professor Kay: Loyalty and prudence are the core fiduciary principles. I was translating them into specifics for the purposes of financial services regulation, but it is loyalty and prudence that lead you to these principles. Loyalty means putting the client's interest first, and prudence, which relates to both clients' interest and conflict, is essentially about doing what you would do yourself if you were in the position of the client.

Q58 Chair: You recommended that the Law Commission be asked to review the legal concept of fiduciary duty, which has been accepted. What do you think the key areas of focus should be, and why?

Professor Kay: There are two parts to the issues on fiduciary duty. The part that we have just been talking about is whether the FSA's or its successor's rulebooks correspond to standards of fiduciary duty. To my mind, they have historically fallen significantly below these kinds of standards. It seems to me that imposing these kinds of standards is essential to the creation of the trust relationships that we have all talked about. Then there is a specific problem of fiduciary duty in relation to pension fund trustees and similar trusteeships. I think you will all have received material from FairPensions, who have particularly developed that issue. It is apparent that there is legal advice around that interprets fiduciary duty in an extremely restrictive and narrow way.

What I discovered in discussion with lawyers in the course of the review was that many lawyers took the view that that restrictive interpretation is not a correct statement of the law. However, it seemed to me that

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that was something that ought to be discussed and resolved in order to clarify what fiduciary duty was. As a matter of fact, in a personal sense, I have a role as trustee in relation to managing the affairs of my Oxford college, and I thought I knew what my obligations in respect of that were when I began the review. I have found myself much less clear at the end than at the beginning. I do not think that is a very satisfactory situation.

Q59 Chair: You have done an awful lot of analysis and consultation on this. Why have you delegated it to the Law Commission, rather than make a recommendation yourself?

Professor Kay: I have spelled out where I would like to be. What I think we ought to have in terms of pension fund trustee obligations is, really, what we talked about earlier. You ought to be required to do what you yourself would do if you were in the shoes of the beneficiaries. That, it seems to me, means that you do not have to behave monstrously and unethically in order to make more money for your beneficiaries, which—to caricature a bit—is one suggestion of how the law is interpreted. Equally, you may not pursue your own particular moral, ethical or political purposes with the beneficiaries' money. We want to define the middle ground between the two: that is, that the morality and ethics that you apply should essentially be those that would be appropriate to the beneficiary.

Q60 Rebecca Harris: One of your recommendations was that asset managers should fully disclose costs, whether estimated or actual transaction costs, and performance fees charged. How disappointed are you that the Government has not decided to make this compulsory?

Professor Kay: That is one of the areas in which I think we should have regulation that could be effective in doing this.

Q61 Rebecca Harris: So when it comes to the Government bringing its progress report forward, you would like to see that there has been substantial progress in this area.

Professor Kay: Yes, on proper disclosure of charges and costs of asset managers, because we don't really know in aggregate what they are.

Q62 Rebecca Harris: How detrimental do you think it is that we don't have this now? How much damage does that do?

Professor Kay: If people knew how much they were paying for intermediary services at the moment, there would be significantly more effective pressure to get that done. There is quite a lot of damage.

Q63 Ann McKechin: Could we just turn to this issue about reporting by companies? You say that much of the information is simply noise. Some people might argue that one person's noise is another person's data. What, in your mind, is too much information, or is it badly presented information that is at the core?

Professor Kay: It is a bit of each. If you look at the report and accounts of large financial institutions like

banks or insurance companies, you get hundreds of pages, and you don't learn very much, even if you go through the hundreds of pages. What is the answer to that? We could make it thousands of pages. Perhaps, to some degree, we should, but I think that if it moves to thousands of pages it will be all the more difficult to go through, and I am not sure that we will be that much better informed when we do it. So, where do we go? There are two directions. One, which is rather outside of my terms of reference—although it something about which I feel strongly—is that these institutions should be made a lot simpler than they currently are. The second is that there should be much more negotiation between users of accounts—the important ones, for our purposes today, are asset managers—and the companies that disclose them.

Q64 Ann McKechin: Do you think that there is a role for the investors' forums in this?

Professor Kay: That could be a positive one in relation to this. Also, the kind of information you need about a company is very much specific to the sector, and even to the company. What you need to know about a bank is rather different from what you need to know about a retailer, and so on. It goes back to this favouring of transactions and trading over relationships. What we have tried to do is to block the provision of information through the relationships and say that companies have to provide a standardised mass of information for everyone. That has created the world that we see, where we get lots and lots of information that is not terribly useful.

Q65 Ann McKechin: You made a clear recommendation about quarterly reporting obligations, and the Government has supported your recommendation. Some people might argue, "How can less information be better?" Is it simply just that you are trying to change behaviour, rather than trying to block information coming out at a particular time?

Professor Kay: The argument that says that more information is always better is tempting, except that we all know that it really is not true. It is very difficult to ignore information, even if it is essentially irrelevant.

Q66 Ann McKechin: The problem is the way it is used, rather than the information itself.

Professor Kay: Yes, and that it is then manipulated. That has been part of the problem with quarterly reporting, which has reached extremes in the US. Companies produce steady streams of reported quarterly earnings. In many cases, they produce steady streams of these quarterly increases, until one quarter they do not because reality has finally broken through. It really has been part of a process of earnings guidance, earnings management: a kind of dysfunctional cycle of relationships between analysts and companies. I think we would like to just get rid of that cycle and have it replaced by, typically, more qualitative relationships between the company and the asset manager.

Q67 Ann McKechin: We are moving away from the crack cocaine of quarterly reporting, and you have

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talked about highquality, succinct narratives. How would you define such a narrative?

Professor Kay: That is difficult. We can invoke certain elements of common sense and audit in this. What we want to avoid, obviously—and what it is very easy to see that we might get—is long narrative reports that are written by PR consultants, which are statements of motherhood and apple pie that do not get into anything substantive about the company. It is quite hard to set a rule saying that what you write has to be substantive.

Ann McKechin: “Avoid the flannel and get to the facts.”

Professor Kay: We would probably transform Parliament, as well, if there was a “no flannel” rule.

Q68 Ann McKechin: Presumably, perhaps, codes of practice should try to give some indication to people about how good reporting could actually be achieved?

Professor Kay: Yes. There is a role, as I have described, for the auditors, and there is a role for an asset manager of a large company, who can say, “This stuff is just not good enough.”

Q69 Paul Blomfield: Clearly, the issue of levels of corporate pay is an issue on which there is lots of public focus. I was actually interested that, although you looked at the structure of pay, you did not feel tempted to comment on the levels of pay.

Professor Kay: I certainly felt tempted to comment, but since there was another BIS exercise looking at levels of pay while I was doing this piece of work, I was encouraged in the view that it was not my business. I received further encouragement from being told, especially at the interim report stage, that if I wrote about levels of executive remuneration, nobody would take any interest in anything else I said.

Q70 Paul Blomfield: I understand that entirely. I guess there might have been wider public interest, and I am reading into what you are saying that you would share the wider public concern about the excesses of corporate pay and their impact.

Professor Kay: Both the structure and the levels of executive remuneration are wrong, yes.

Q71 Paul Blomfield: You did then talk about—in terms of structure—linking more to long-term performance, but you also acknowledged in your report that that was what most companies said they were doing anyway.

Professor Kay: They said they were doing that, but a threeyear longterm incentive plan does not seem to me longterm, in terms of building great British businesses.

Q72 Paul Blomfield: So recognising that, you then came out, trying to move things forward, with the specific recommendation that incentives should only be provided in the form of company shares to be held at least until after the executive had retired. Were you then disappointed by the Government response, which just said that the structure of remuneration should be determined by individual companies in consultation

with their shareholders? That does not move things forward at all.

Professor Kay: It does not move things forward anything like enough. As I indicated earlier in the discussion, I think that the pursuit of particularly elaborate bonus schemes for executives has just been a serious mistake. It has been damaging, both to individual companies and to public perceptions of business. What I want to see is people running large British companies whose primary motivation is that they want to build great British businesses.

Q73 Paul Blomfield: As such, the Government response really fails to address one of your most substantive recommendations. I wonder, therefore, whether you felt that that recommendation should be made compulsory, notwithstanding your antipathy to regulation. In your report, you develop a very effective critique of selfserving circles of remuneration consultants. I am also minded of the report in the last few days, regarding the way that the chair of the remuneration committee of Barclays was heavily disregarded by the chairman of the bank when she made recommendations on remuneration there. Therefore, have things got to the stage at which we need to look at your recommendation being made compulsory?

Professor Kay: I think that there is an argument for that.

Q74 Chair: We are nearing the end now. I just had one or two questions. The first is relevant to long-term thinking. Aviva provided us with evidence that the average holding period for UK equities had fallen from eight years in the 1960s to just seven and a half months in 2007. Do you think that there is a case for reconsidering a financial transactions tax, not so much to raise revenue, but potentially to reverse this trend?

Professor Kay: Yes, there is. If we could have a financial transactions tax that worked, it would seem to me to be a very attractive way of discouraging that trading activity in favour of longterm investment. It is clearly very difficult to structure a financial transactions tax that works, and I have two large worries about this. One is that I have observed the financial transactions tax that we have at the moment, which, far from discouraging trading, is actually solely a tax on longterm investors. Someone described it to me as a tax on UK pension funds and private individuals, and that is essentially what it is. We have been very unsuccessful so far.

There are clearly a lot of things that, if we introduce a simple financial transactions tax here, could be done to avoid it. The danger is that we simply shift a great deal of equity trading into other—possibly less regulated and probably offshore—forms, and into more complicated instruments of various kinds. We have to be reasonably sure that we can structure a tax that will not do more harm than good, but if we could, I would support it.

Q75 Chair: That is an interesting response. You are an expert in this area; could you do it? I am not trying to give you a job; I am just interested to know.

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Professor Kay: I have, and I have discussed with other people, ideas about how one might structure this. It is genuinely quite hard. There only have to be a few large loopholes—I am going to mix my metaphors—and people will drive a coach and horses through them. We know, for example, that a very large amount of shortterm trading in UK equities already takes the form of contracts for difference, rather than direct purchase in sale of shares. We can do things about that, but then we have to look at things that would be done to evade or avoid the impact of that. It is complicated. I am not sure that it is impossible, but it is not easy.

Q76 Chair: That is interesting, and we may want to pursue that a little further with other speakers. Could I move on to highfrequency trading? You did not make any recommendations about this. Why not?

Professor Kay: There were two reasons. One was that there was another BIS exercise on highfrequency trading being conducted at the time. The other was that, although the existence of highfrequency trading is not something that one could say is very supportive of longterm decision making in British business, I concluded quite quickly that it is not the principal issue and problem, which is to do with the behaviour of the longterm holders. You quoted the Aviva figure for the average holding period. Of course, that is greatly affected by large amounts of very shortterm trading, but it is not surprising when you think about it. If you look at the numbers, although much of the turnover is accounted for by very shortterm traders, that does not mean that very shortterm traders own a very large proportion of British business. They do not. Most shares are actually held by rather longerterm investors, so that leads one to the perspective that the issue that we need to tackle is getting the incentives and approaches of the longterm investors right.

Q77 Chair: I will accept what you say as being probably correct. However, it is equally true that it has precipitated stock market volatility in some countries. I believe that the German Government intends to introduce a law to clamp down on it, because of this market turbulence. Do you think that is the right approach?

Professor Kay: It goes back to the discussion that we have just had about a financial transactions tax. It might be a good idea if you could introduce something that you were confident would work. I rather fear that, if the German Government introduced it, it would just mean that trading would not take place in the environments where the German Government's jurisdiction ran.

Q78 Chair: So do you think that it might help the British environment?

Professor Kay: Possibly, but I think that we should not feel very proud of that.

Q79 Chair: Could I just go back again to the Cadbury situation? As a West Midlands MP, it is obviously a little bit of a preoccupation of mine. Earlier, I asked you about the role of short-term investors in the company, and you said that basically the final share price was determined by the commitment of Kraft to pay that. That probably is the case. Do you think, therefore, that shortterm investment or speculation on this scale is irrelevant to mergers and acquisitions in this country?

Professor Kay: I do not think it is irrelevant, because you made a point a moment ago about the volatility of markets. One of the effects of a rise in the volume of trading across financial services has been to create greater market volatility. Merger and acquisition activity is in part a function of market volatility. It creates more opportunity, and that feeds back on itself.

Q80 Chair: Do you think that there is a case for disenfranchising shortterm investors of the nature that invested in Cadbury?

Professor Kay: When I talked about shortterm investors there, I meant shortterm investors in a much broader sense. As we were describing, I do not think that the result in the KraftCadbury case was basically fixed by the existence of arbitrageurs and other shortterm investors.

Q81 Chair: I accept that, but do you think there is a case? Would it impact on the level of mergers and acquisitions activity?

Professor Kay: If there was less short-term trading, I think it would.

Q82 Chair: That is interesting. Could I just conclude with another one? One of the policies that has been introduced, and is proving slightly controversial, is the 28day "put up or shut up" conditions that arose very much out of the Cadbury situation. Have you any views on that?

Professor Kay: From what I have said earlier, you will see that almost anything that puts a bit more sand in the wheels of the merger and acquisition machine is something that I would welcome.

Chair: On that note, can I thank you for your contribution? It is a very useful opening. Obviously, we will be talking to a whole range of representatives from the industry, Government, and lobbyists on this, and we will come to our conclusions in due course. At the moment, can I just thank you for your contribution? It is a very helpful start to this particular review process.

Professor Kay: Good. I am glad that I have provoked your interest.

Thursday 14 February 2013

Members present:

Mr Adrian Bailey (Chair)

Paul Blomfield
Rebecca Harris

Ann McKechin
Mr Robin Walker

Examination of Witness

*Witness: Lord Myners CBE, Former Financial Services Secretary and author of *Institutional Investment in the United Kingdom: A Review*, gave evidence.*

Q83 Chair: We are slightly early, but I see no reason why we should not start. Can I thank you and welcome you? Obviously, you have a unique insight into this particular issue, and we would welcome the opportunity of questioning you on it. I understand that you would like to make a short opening statement, so I will invite you to do so now.

Lord Myners: Thank you, Mr Chairman and members of the Committee, for inviting me to give evidence. By way of disclosure, I am a director of three investment funds and three public companies. It is a pleasure to be here in the Wilson Committee Room on the 50th anniversary, to the day, of Harold Wilson becoming Prime Minister for the first time.

I have spent 20 years in the investment management industry, most of them as a CEO of an investment company in the City. I have also been a director of a sovereign wealth fund. I spent a dozen years as a corporate director of companies, including Charing Marks & Spencer and Land Securities, the largest quoted real estate company in Europe. As such, I have seen the issues covered by Professor Kay from the perspective of both the institutional investor and the company director, and also from the perspective of being a trustee of pension schemes.

I have done five reviews for Government on issues relating to ownership and stewardship. I did two for the Department of Trade and Industry during the previous Conservative government. The broad thrust of those was evidenced in their titles: one was called *Developing a Winning Partnership*, and the other was called *Creating Quality Dialogue*. They focussed on this space between companies and their owners, or their surrogate owners. I also produced three reports for the Treasury: one on institutional investment in 2000–01, another on the governance of mutuals, and a third one on the financing of high-tech companies.

Professor Kay has produced for us an academic treatise, which is very well argued. It identifies the core issue, which is the emergence over the last 30 years of a transactional relationship between companies, investors and intermediaries, and the dominance of the financial intermediaries, matched by a steady erosion of trust as the basis for commercial relationships. Essentially, we have seen the adoption of an “eat what you kill” culture in the City, as opposed to a culture in which one behaves more as a GP would towards a patient.

However, the Professor fails to come up with many practical proposals beyond wishful thinking. I sense that he lost heart towards the end. He was worn down by the weight of institutional lobbying, and we can

see similar evidence of that in the response from the Secretary of State. I do not think that the Professor’s report will add a jot or tittle to the prosperity of the UK economy and the success of our businesses. If the test is whether, in 2022, we will look back and say, “10 years ago in the UK we had the Kay Review report, and everything changed,” I think that test will most assuredly fail.

Kay offers no route to reversing the decline in the relative expenditure in the UK economy on research and development, or the decline in the commitment of fixed capital in support of employees. There is nothing in the Professor’s report that will end the dominance of markets over users; there is nothing in the Professor’s report that offers the prospect of the stock exchange becoming a primary source of new capital, as opposed to a secondary trading market; and there is nothing in the Professor’s report that seriously challenges the value and job destruction associated with reckless merger and acquisition activity.

The Professor barely penetrates the carapace. In some places, he is contradictory. He wants less intermediation, and yet he proposes a new intermediation body. The Professor faces both ways on short trading, as Mr Walker exposed in his cross-examination. There is a lack of consistency. In other areas, the Professor simply misunderstands the issues. When discussing stock lending, he fails to understand that these are not lending transactions: rather, these are re-purchase transactions. He focuses on reward, and almost completely ignores risk.

In other areas, the Professor’s recommendations are irrelevant. The recommendation on risk modelling is one that both the Secretary of State and the industry have almost completely failed to understand. I cannot work out what he is really getting at. The Professor also gives up in other areas: we have a lot about M&A, containing an element of xenophobia, but in the end he comes up with absolutely nothing in terms of a tangible recommendation.

However, I reserve my greatest disappointment as far as the Professor’s report is concerned for his complete failure to follow up on some of the very best ideas originally floated in his interim report. We find nothing of any significance in his final report on the subject of taxation, or why a trading culture is promoted by tax exemption. We find nothing in his final report about a financial transaction tax, which would slow down the pace of hectic activity in the City that sees trading now timed in microseconds of ownership, rather than anything that represents the sort of vision the Professor would like us to believe in.

He says nothing about employee ownership. He does not build on the work of the Bullock Report, released 36 years ago: he completely ignores it. He says nothing about slowing down the speed of merger and acquisition activity. In fact, he endorses the Takeover Code changes that speed up takeover activity in an economy that already has the most permissive rules in the developed world for taking over companies. There is no other economy in the world where it is easier to acquire a company than in the United Kingdom.

Despite having mentioned it in his interim report, he says nothing about the stewardship model in Scandinavia. In this model, the institutional investors sit on the nominations committee. They choose the directors. They make sure the directors are truly accountable to the owners of the business, as opposed to the directors being appointed through a process that is largely dominated by the Chairman, and through a voting outcome that even the North Koreans would be embarrassed by. He says nothing about differential voting. He says nothing about repairing the flaws in the voting system.

He misses major areas of great significance and importance. Even more fundamentally, he does not ask what the purpose of a public company is. He says early on in his report that public listing is now not a major source of capital for investment, but he does not get deeper into the question of whether we have too many public companies. He does not ask whether it would make more sense if our institutional investors owned these companies as private businesses, owned perhaps by two or three pension funds, who were able to appoint their own directors. This is as opposed to them owning 2% or 3% of each company and taking little interest in how those companies are managed. If I may say, in promoting private ownership of companies, I am not promoting private equity. I am simply saying that large pension funds could own private companies. They do not need liquidity.

In closure, Chairman, the industry's response to Kay is, I think, one of considerable comfort. It might be summed up with: "Move along, Sir. Nothing much to look at here." There has been no disturbance or disruption to a highly remunerative business model. I doubt whether anybody who comes to give evidence to you will have much concern regarding Kay, other than, conceivably, the people from FairPensions.

I am nearly finished, Chairman. I know I am stretching your indulgence. I apologise for that, but I am trying to give a sense to the Committee of where I come from. I know it is important for you to read your own report into evidence that is given to you.

One area in which Kay approaches tangible recommendations, as opposed to wishful thinking, is that of a forum for investors. I have previously endorsed this concept myself. I have talked at length about ownerless corporations, and the need to create a better nexus. However, Mr Chairman, little progress has been made on establishing this forum. One or two people are trying; Daniel Godfrey, of the Investment Management Association, is one. However, what we will end up with is a forum that is dominated by trade associations, and trade associations' modus operandi—their purpose for existing—is to protect the status quo. It is not to change things. I think you will

find that, at best, this is run on a part-time basis. It will not have a fully paid secretariat. It will not have a significant budget. Sovereign wealth funds will stay well away. There may be some face-saving approach in which they are given associate or observer status, but they will have no interest in being part of this investment forum.

I will be one minute, Mr Chair, or less than one minute.

Chair: We would like to get some questions in.

Lord Myners: The Secretary of State should, in my view, have taken a much stronger line. He should have said, "I want to see this forum established." He should have invited two or three people to produce a short report over 30 days regarding what the options are, and he should have said that this can be financed out of the PTM levy, which is the £1 charge that appears on a contract note. This is used to pay the City institutions who staff the Takeover Panel, so this works well for the City institutions. Why can that not be used to pay for stewardship? Why can directed commissions not be used to pay for stewardship?

Likewise, on the issue of looking into the legal issues around fiduciaries, as far as I am aware, Mr Chairman, very little progress has been made with the Law Commission.

Chair: We will be asking questions on that.

Lord Myners: I think, sir, that we ultimately have a report where the reviewer and the Secretary of State have both been nobbled by existing interests. The British Horseracing Authority would probably order an investigation if they received a similar report that was so lacking in penetrating analysis or strong recommendations.

Q84 Chair: Thank you. I am not sure whether I would draw a parallel between this Committee and the British Horseracing Authority, but we will certainly be holding a similar sort of inquiry.

That is a pretty comprehensive opening statement. It may have anticipated some of the questions we intended to ask, but I think it is fair to say that it could generate further questions, which may or may not be picked up today. Once we have read the transcript of your opening statement, we may well write to you with some further points to be clarified. Your opening remarks are a pretty robust criticism of the Kay Report. You yourself made a report 10 years previously. In many ways, your approach was quite similar to Kay, in terms of commitment to the voluntary approach. What parallels would you draw between the two reports, and why are you so critical of Kay, given that there is not a great deal of difference in approach from your own, 10 years earlier?

Lord Myners: That, Chairman, is a very fair comment. The answer is that I am very disappointed in the lack of progress after my report on institutional investment in 2001. As you say, it relied on the same statements on principles of best practice that Kay is continuing to rely on. I have come to the conclusion that there are some fundamental flaws in our current approach to corporate ownership, in which most of our very large companies are owned by an extraordinary number of institutions, all of whom own

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a tiny percentage. None of these institutions feels empowered or obliged to act like a true economic owner. All of them, with a few noble exceptions, see selling as a better option than getting actively involved when they see a company failing to invest or perform well.

That is why I come back to the conclusion, Chairman, that what I have described as the “ownerless corporation” can only be successfully addressed if we see a fundamental change. There needs to be more concentrated ownership, and more activist shareholders who are properly equipped and empowered to become involved. Another important step in that respect would probably be for a smaller proportion of our economy to be in the hands of publicly listed companies.

A number of the areas that Kay picks up, such as the costs of transaction and the failure of investors to get actively involved, are ones that I have previously addressed. He seems to address them as though they are novel and have not previously been looked at. In fact, there is a long succession of reports on these areas, including that of the Wilson Committee, which I think was before the Bullock Committee. There is very little in Kay’s early chapters that represents any fresh and additional perspective on these issues.

Q85 Chair: One of the problems, as I see it, is that both you and Kay were pretty strong on analysis but both reports have been weak on providing a route map from the analysis to the objective that you would like to achieve. You talked about more concentrated ownership. How can you get more concentrated ownership without intervening in the market in a much more direct way?

Lord Myners: The answer here is, I think, the same one that I gave in 2001. The ultimate owners—in most cases the trustees of pension funds or endowments, or the directors of insurance companies—need to ask themselves whether this current model is working successfully from their perspective. Kay makes the point, from which I do not dissent, that the current model works very well for the agents. It works well for the fund managers and for all those who are giving advice, such as the consultants and other intermediaries. What we need here is a more fundamental review by asset owners regarding whether this model works.

As I said, my contention would be—and it is interesting that some of the sovereign wealth funds are moving in line with my contention—that they do not particularly want to invest in listed companies. They would rather invest in private companies, where they can exercise more control, or, importantly, they want to invest in companies that have anchor shareholders. These are strong, significant, long-term shareholders who are represented on the board of directors and who take a real interest in what the company is doing, rather than people who are just trading bits of paper. The problem is that our big companies are now owned by share traders. They are not owned by investors.

Q86 Chair: How can you proscribe that?

Lord Myners: I don’t think you can proscribe it with absolute confidence, Chairman. However, I do think that Kay is right on the issue of fiduciary duty. I think it would be beneficial to have a more serious set of statements about fiduciary duty, in which, for instance, the trustees were placed under an undoubted and undeniable obligation to properly account for how they align the way in which they invest with the best interests of members of the scheme.

Q87 Chair: I am going to ask some questions subsequently on fiduciary duty. If I can just come back, I believe you told the *FT* in 2011: “You can sum up my report in four words: a call for action.” That goes back to your report in 2001. The fact that we have had the Kay Report does demonstrate that that level of action has not actually been generated. It comes back to this core issue: how can you change a market that seems to work well for some, when they have such a strong vested interest in sustaining the model as it now is, irrespective of the economic benefit to the actual investors?

Lord Myners: I think my own report—which was a call for action, and primarily a call for action by asset owners—did have some impact. I think that the direction of travel was right. I am a naturally impatient individual, and therefore the speed and length of travel was not as great as I would have liked. One of the phrases I like in Kay’s report, Chairman, is about market abuse. He says the very fact that we call it “market abuse”, rather than “customer abuse”, tells us how our whole thinking—including the regulators’ thinking—demonstrates that we believe the market is our saviour here. The market is not our saviour. We have learned that markets are not as efficient as an economist might suggest. We know that markets lead to crowding, in terms of everybody moving in the same way. We know that a reliance on markets does not ensure safe outcomes for clients of financial services companies and investors. We need to reassert, or assert, the primary interest of the asset owner.

The problem is that most of the people who have contributed evidence to Kay, who are listed at the back of his report, are agents. They are people who say, “This system works very well for me. I don’t want to change this at all.” How, therefore, do we give voice, power and expression to the people through their savings and investment schemes? There are radical options, which I think Kay should have considered. He does not consider employee ownership at all. He does not ask whether it would be better if we found a system where, for instance, companies were required to put 0.5% of their new shares into an employee trust each year, until such point as the employee trust became the largest shareholder in the company. For most companies, Chair, it would take seven or eight years to get there if it was 0.5% per annum.

It would not take very long at all, and there would not be much dilution, but it would represent a fundamental change in the market. Kay does not consider anything as radical as that at all. He stays in these very narrow tramlines of conventional thinking, with nothing in his report that disturbs the City institutions.

Q88 Chair: I am sure those comments will be music to the ears of the employee-share ownership movement. Looking at the market, and trying to understand what has happened for us to get where we are at the moment, you reported in 1999 that only 15.3% of UK shares were held by individuals. Kay reports that in 2010 that figure had fallen to 11.5%. Why has this happened, do you think?

Lord Myners: Data around ownership is highly suspect, because of the way in which shares are registered through nominee companies. For instance, if a UK pension fund is managed by Fidelity, which is an American company with a UK office, is that registered as American ownership or British ownership?

One should treat the data with some caution, but the central thrust of the decline in individual ownership is undoubtedly correct. I would venture to suggest, Chair, that the financial services industry has been very successful in lobbying government to ensure that people are encouraged to invest through funds, rather than themselves. Funds have a tax-preferred status: if you invest yourself, you pay capital gains tax, but the fund does not pay capital gains tax. If you want tax protection through an ISA, you have to make it through a fund. If you want to invest in venture capital, you have got to do it through EIS or a VCT. The industry, at every point—whether on charges within funds, on disclosure, on tax enabling, or on regulatory restrictions—has consistently directed Government and Government policy towards the promotion of fund-based investment rather than individual investment.

Q89 Chair: That is an interesting point—that the industry has exercised pressure on the Government. There is a whole range of government saving schemes that would conform to the model to which you have just referred. You feel that has come from pressure from the industry, rather than from a Government approach to adopt the most risk-averse way of encouraging the public to save?

Lord Myners: Government may well have been persuaded—indeed, was undoubtedly persuaded—that it was an outcome that was risk-averse and in the customer interest. Government was equally persuaded that previous restrictions on maximum charges for unit trusts should be lifted, and of other things that suited the industry very well. What we know, Chairman, is that most unit trusts—90% over periods of more than five years—underperform the index. This is extraordinary. 90%—nine out of 10—professionally managed funds produce a worse return than you would get by throwing a dart 50 times into the back page of the FT and buying the shares where the dart penetrated the paper. Somehow, Government has been persuaded that this is a safe and good outcome for the customer, when the data might at minimum suggest it is not as simple and straightforward as suggested. However, it is an outcome that has suited the fund management and banking industry very well.

As you hear, Mr Chair, I am quite cynical. I have been in this industry for a long time. I was also, of course, a junior Minister—a very junior Minister—for 18

months in the previous Government. I had first-hand experience there of seeing how the financial services industry lobbies HMRC, the FSA, and the Treasury.

Q90 Chair: You spoke earlier about the difficulty of identifying the true ownership of UK shares. You can quibble about figures, but it does seem to me that there has been an increasing level of ownership based outside the UK. When you did your original report, did you anticipate that, and did you factor that into the recommendations that you made?

Lord Myners: No, I did not, Chair, but it was an extrapolation of a trend that has been in place for a long time. Of course, there is a reverse to this as well: more foreign institutions own a significant part of the UK quoted sector, but more UK institutions now have their money invested outside the UK, and there is a lot of academic evidence as to why it makes sense to diversify portfolios geographically. The consequence, as far as the Professor's report is concerned, is that generally speaking—one has to be careful about too much high-level generalisation, because there are commendable exceptions like BlackRock and Fidelity—overseas investors take less interest in issues of governance and ownership in their non-domestic markets.

This is also true of our institutional investors, who are much more focussed on the governance of UK companies than they are on the governance of Indonesian, American or Mexican companies in which they may have invested the savings of their British clients. This is a global trend, Chair. It cannot be reversed within the limitations of the public company model.

Q91 Chair: It is an interesting observation. On the basis of what you have said, with the increase in globalisation of share ownership, there is potentially a decrease in quality governance throughout the world.

Lord Myners: Yes.

Chair: It is difficult enough to get action in this country, but do you think that there is a case for trying to get some sort of international model?

Lord Myners: I will be very interested, Chair, to read the transcript from when you interview people who are supposedly establishing this investor forum, and to see how successful they are in convincing you that they are going to set up something that is really meaningful. My suspicion is that you will have significant doubt. I would then suggest to you that, if they cannot do it alone in this company, it is going to be almost impossible to do it globally.

If I may briefly add another point here, Chair, I am less concerned about the internationalisation of ownership than I am about the agglomeration of ownership in the hands of a small number of very large investment institutions. The problem we have here is that a large institution might own 5% of a company's capital. Therefore, for the company, this institution is very important. They are the largest shareholder: they own 5%, and the company will want to have an active dialogue. However, for the large institution, it might be an infinitesimal amount of their total assets under management.

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The company will want a close engagement, and Kay talks about the appointment of directors and these sorts of things. Although the company wants and expects that, the institution will have thousands, tens of thousands, or hundreds of thousands of these little investments. How can they possibly think and behave like true economic owners? That, Chair, is—I believe—the fundamental flaw here. We have come to believe that the public company model is a superior one, and it clearly is not. It is failing in terms of its primary economic purpose.

How can we fix it in the interim? There need to be more activist shareholders who take significant shareholdings, around 10% or 15%. They need to appoint people to the board, which means they need to be engineering that themselves in terms of the skills they need to do that, and they need to commit long term to be an anchor shareholder in that company and have the right skills to work in the board of directors. That is a radically different model from the one that we have at the moment, which I have characterised as the “ownerless corporation”, where nobody cares much about what happens in a company. If it looks like it is all going to go wrong, we simply sell our shares to somebody else and exit.

Q92 Ann McKechin: Good morning, Lord Myners.

Lord Myners: Good morning, Ms McKechin.

Ann McKechin: You talked in your own report, back in 2001, about the importance of attempting to seek an effective approach that does not rely on direct government intervention in banning or directly determining behaviour. Professor Kay recommended a fairly similar approach. However, this morning, you have mentioned a more activist shareholder base, and you have talked about employee share ownership. Presumably, you cannot actually achieve employee share ownership without a certain amount of compulsory regulation. In what way do you think that your original “comply or explain” principle did not work, and do you think that there is now an argument for greater compulsion?

Lord Myners: There are many things in my original report that I stand by. In particular, I stand by the importance of having trustees who are better qualified, more knowledgeable and more independent-minded, and who approach their responsibilities in a more business-like way. However, there are issues around the public company model that I see with greater clarity now than I did 10 years ago. I perhaps failed in that respect. There are areas where I think Government could, and should, intervene. Government should force the creation of this investor forum, and it should say that the financial means will be placed there for it, potentially through a contract note tax. The tax I referred to earlier on is £1 per bargain, and even then only applies to more than ten thousand shares. It is noise. I would like to see that forum correctly funded, properly staffed, and truly independent of trade bodies.

I would like to see the Secretary of State take a much stronger line on takeovers. I look back at Dr Cable’s speech to the Liberal Democrat party conference in September 2010, in which he talked about speculators dominating our economy; businesses being destroyed

by short-term gain; and vandalism, aided and supported by City accomplices.

Chair: We will be talking about takeovers in a moment.

Lord Myners: I then look at what he says in response to Kay. One can only assume that his words are drafted by the same officials who worked with Kay, because they are marking their own homework. They are saying, “Everything is alright, gov. We don’t really need to do much on takeovers,” but we do. We need to put a public interest test into takeovers and we need to slow the process of takeovers down, in order to give companies an adequate opportunity to prepare alternative proposals for their shareholders.

Chair: Could I just intervene? We do actually want to talk about takeovers in a second.

Lord Myners: I apologise.

Q93 Ann McKechin: You have mentioned several times this morning the institutional reluctance to change and how dominant their lobby has been in all aspects of their work. Professor Kay generally said the problem was that, although you can certainly change the regulatory environment, there is always a danger of people trying to find another option that they believe will be more preferable to them. You may also get a culture of box-ticking and false security. I wondered how you try to navigate these problems. If the institutional resistance is great, how do you try to nudge people into a better behavioural pattern?

Lord Myners: It is extremely difficult, Ms McKechin. Your colleagues in the Banking Commission down the corridor are wrestling with the same issue around the ring fence.

I think Kay is absolutely right in emphasising this issue of fiduciary responsibility. We need to place great clarity around the concept of the intermediary—the adviser—acting wholly and unquestionably in the best interest of the client. At the moment, we know that is not the case. The test is one of fairness and disclosure, and Kay himself makes the point that in, for instance, the area of what he calls “stock lending”, disclosure is inadequate. For the life of me, I cannot understand why the Department for Business, Innovation and Skills has not got on with the process of getting the Law Commission to work on the Kay recommendation. I am hopeful that, as a result of what I say here and what you are doing, Dr Cable will be able to tell you that this work has started by the time he gets here. I am pretty confident that, at the moment, it has not started. There needs to be clarity about fiduciary responsibility, backed up by a tough regulatory regime that says: if you misbehave, you are out—and out for good.

Q94 Chair: Can I just intervene on both you and Ann with a question I was going to ask later? I think it is appropriate to do so. There has been criticism of this recommendation to give it to the Law Commission to look at as just another way of kicking the issue into the long grass. How do you feel? Do you feel that this is a fair criticism?

Lord Myners: I have often found in my professional career, and also in the work I have done on reviews, that I have been given too much time. I am now a

great fan of saying, “Let’s get these reviews done quickly. You will get 90% of the answers in 30 days. You may get the last 10% if you make it 300 days.” That is why, if I were the Secretary of State, I would have had the Law Commission addressing this already, and would have had that investment forum up and running.

Kay is a man whose motivations are unquestionably good. I just do not think he has dug deep enough, or been radical enough. I think Kay’s recommendation here is a serious one, and it would be good to have more clarity about fiduciary duty. Maybe this is one for the Financial Conduct Authority—which is about to be launched—to deal with. There should be an absolute, undeniable obligation never to abuse a conflict; always to disclose conflicts; and, indisputably, never to disadvantage the client or put your own interest first. If you look at the language around financial regulation, you will find that it is a bit mealy-mouthed. It is a bit qualified. It is caveated, and we need to have absolute clarity here.

Q95 Chair: Would it be fair to describe your approach to this as saying that, although it is the right course of action, it could be done a lot more quickly?

Lord Myners: Yes. It would have been very nice if, in the Secretary of State’s responses—which are all couched in the language of officialese—we had felt a little bit of Dr Cable himself. That was not there. There are about three or four ways in which Dr Cable could have been much more forceful than he has been, if he really believed in these issues and if he really went back to the spirit of his views in September 2010.

Chair: Sorry, Ann, I will bring you back in.

Q96 Ann McKechin: Thank you very much. You carefully set out a series of principles to codify the model of best practice for institutional investors, and pension schemes in particular. Two years later, the Government conducted a review of the take-up of these principles in the industry. I just wondered how satisfied you were with the progress that was made on that issue.

Lord Myners: The subsequent two-year review watered down my original recommendations. That was, I think, the product of successful lobbying by vested interests. Past experience of mine—and, dare I say, of yours—might suggest that, when we get the 2014 summer review of Kay, we may well find that there has been some watering-down then. There are very few parallels where you would say, two years on, “It was tightened up.” The whole pressure of vested interests, here as in so many cases, will be to reduce impact. I was a tad disappointed.

Q97 Ann McKechin: Did it get weaker after that two-year review?

Lord Myners: Yes, it did. It gets weaker every year.

Q98 Ann McKechin: It is constant effort. Professor Kay has published a new set of principles, called “Good Practice Statements”. The Government has, again, taken a rather hands-off approach, saying that they should prompt market participants to consider

their current progress and inform industry-led standards of good practice. How long would you recommend that we wait to see if that approach works, or would you say that we should have moved a lot quicker?

Lord Myners: I think we could probably wait until this afternoon.

Ann McKechin: It is not going to happen.

Lord Myners: It is not going to happen. Despite the protestations of others, who will now come and say, “You had Lord Myners here, and what he said was totally unfounded,” I rely upon your expert judgments of people and institutions, and your experience, to form a view as to whether you think much is going to happen here. My strong sense is that it will stay as it is.

Q99 Ann McKechin: You have mentioned fiduciary duty, and you have also mentioned conflict of interest. That is interesting, because conflict of interest should be quite clear to establish. Are you saying that has got to be the real emphasis, and people have got to be pressed very, very hard about conflicts of interest and the rules should be enforced rigidly?

Lord Myners: Conflicts of interest are inherent in all business transactions and, indeed, in all aspects of life. What is needed here is an absolutely clear statement of those conflicts, but I do not think statements are sufficient in themselves. I think a legal obligation is required. I was brought up in Cornwall, and my mother was a hairdresser. She knew nothing about business. She once said to me, “You manage £6 billion. Can you write that down for me?” I wrote it down, and she said, “That is an awful lot of noughts. Why would anybody trust you?”

Trust is of a very, very high order. I know this is different from LIBOR, but what we have seen—and Kay’s central observation about the need to get back to trusted behaviour is correct—is that many, many people have lost that sense of honouring the trust placed in them.

Ann McKechin: Thank you very much.

Lord Myners: Thank you.

Q100 Paul Blomfield: Lord Myners, your breathtaking critique of the Kay Report is hugely engaging. One of the things that Professor Kay talked to us about was the difference between equity markets as they are and as they were historically. Companies basically now finance investment through debt and retained earnings.

Lord Myners: Yes.

Paul Blomfield: You would agree with that?

Lord Myners: Yes, I do.

Q101 Paul Blomfield: I guessed that you would. We have had evidence from the Quoted Companies Alliance that disagrees with this, saying that “equity markets remain an essential source of capital for new investments in British business”. Given these conflicting views, what future role do you see for the equity market in the long term?

Lord Myners: I have suggested—and this has been one of my key arguments—that perhaps too many companies are publicly quoted, and that for some of

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them it would be better if they were institutionally owned than private. The primary source of new flotations and new capital in the UK stock market in recent years, and the primary provider of funds, has been Her Majesty's Government in their financing of the banks. It is a bit naughty of the Stock Exchange to include that as evidence that the capital markets are performing a function: I would argue that the capital markets had clearly failed, which is why the taxpayer had to step in.

Of course, we have also seen a lot of Eastern European and emerging market companies coming to the market, but there are very few examples of UK companies coming to the stock market with what is called an "offer for subscription", as opposed to an "offer for sale". An offer for subscription is when a company raises new capital: they issue new shares to new investors to support investment. An offer for sale is when the existing owners, be they private equity, oligarchs, or whoever else, sell the shares that already exist. The capital has already been invested. In many cases, you see companies saying in their prospectus that "the company has no present plans for the use of the funds raised" when there is an offer for subscription.

The fact is that often offers for subscription do not have a clear investment programme linked to them. In any case, offers for sale dominate over offers for subscription, and more small UK companies withdraw from the stock market, rather than come to the stock market. This all seems to me to pull the rug completely out from under the argument that the Stock Exchange is a key provider of capital for British industry.

Q102 Paul Blomfield: Thank you. I know Robin is itching to get in on takeovers and acquisitions, and to follow that discussion further. I wonder if I could just ask about one other point that you raised. You criticised Kay for saying nothing about a financial transaction tax. If you listened to the report on Radio 4 this morning, you would have heard a debate around the movement within Europe: whether all 11 countries could, on a Europe-wide basis, move towards an FTT. It was all about the money that was raised. In your criticism of Kay, you were talking about microseconds of ownership, and some of us struggle to understand this. What is your view on the FTT in terms of changing behaviour, as opposed to raising revenue?

Lord Myners: I did not listen to the radio this morning, Mr Blomfield. I was a bundle of nerves in preparation for coming here, and so I did not allow myself to be distracted. I know I have been critical of Kay, but, as I have said, it is a good analysis. I am just fearful that not many other people coming before you are going to give contrary arguments, so I probably over-emphasised some of my criticism to ensure the balance of argument there.

I am positively inclined in support of a financial transaction tax to slow down the pace of hectic deal-making and trading. I am not much persuaded by arguments to hypothecate the proceeds for one reason rather than another. I think the primary economic argument for a financial transaction tax would be to reduce the super-hectic activity, which, to me, is

epitomised by these high-frequency, algorithmic traders. These are people for whom physically getting their computer closer to the stock exchange, or using even faster bandwidth cables, is critical for business success because they own the shares for microseconds. What have we done? How have we ended up in a situation where the evidence and responsibilities of ownership of our major companies can be traded in milliseconds? I don't think Kay really got to grips with that at all.

Q103 Paul Blomfield: What about the argument that, if we do move towards FTT for that reason, it has to be all or nothing? There has to be complete international agreement, or it will damage our financial services sector.

Lord Myners: The Government is correct in arguing in favour of, ideally, a global FTT. It is quite difficult to introduce. It is quite interesting that EU proposals seem to be extra-territorial, and will apply to transactions conducted in UK securities and by UK-based institutions. I do not think the Treasury has ever looked seriously at the economic case. I think they have been somewhat dismissive, because they see it as threatening to the City. One thing that I think both Professor Kay and I would agree on is that we have too often been concerned about things that are threatening to the City, and have missed the point that, at times, the City is threatening to the economy. I find myself increasingly drawn towards a financial transaction tax: ideally, one that is established globally.

What if it were not global? This is a bit like offshore financial centres. My simple solution to offshore tax centres is that we should not allow any bank in a developed company to establish a branch or a subsidiary in an offshore centre that does not comply with the OECD's white list of financially compliant economies. You could do something similar in terms of transactions. You could say to the Barclays, the Citibanks and the Société Générales that, if they put transactions through a non-FTT-compliant jurisdiction, they would lose some of their financial privileges from being in well regulated markets. I think these things could be achieved, Mr Blomfield, if there is the will to do them.

Paul Blomfield: Thank you.

Q104 Chair: Before I move on, did you consider doing those things when you were a Minister?

Lord Myners: There are lots of things I wish I had done when I was a Minister. I wish I had spoken up more than I did. I came in as a Minister just after the collapse of Lehman Brothers, specifically to do work on the recapitalisation of the British banking system within the Treasury. I was very rarely consulted by colleagues on tax matters, but I do wish I had spoken up on this issue.

Chair: Thank you.

Q105 Mr Walker: Lord Myners, you have given us plenty to chew on. It has been a very interesting discussion so far. I want to touch on M&A, but, first, a broader question. I think that you and Professor Kay have been very clear in your criticisms of the current

nature of the City, the way it treats companies, and the way it has changed the nature of ownership. I think we can all feel sympathy with some of the criticisms that have been made. However, are you not both open to the accusation that you are trying to turn back the clock to a mythical time in which all investors behaved well and understood their fiduciary responsibilities? Are not some of the changes really to do with technology, the rise of globalisation and the fact that we are living in much smaller world, where investors have much freer movement of capital? Is it not unrealistic to think that we can necessarily change all of that through legislation or regulation?

Lord Myners: That is a very good question. Your background in financial PR shines through. No, I don't think I am trying to take us back to some golden age. I am asking whether everything that is listed under the heading "improvement" is actually an improvement. One does need to emphasise that, on the whole, fund portfolios now have more holdings than they used to. That is a high-level generalisation, because you have got some very commendable activist funds that hold investments in only eight or 10 companies, but, generally speaking, portfolios have become more diversified. Academia has encouraged this though modern portfolio theory and capital pricing models.

I am suggesting that it has gone too far. I think high-frequency trading has gone too far. I think M&A—which I know you want to come back to, Chairman—has been hugely damaging to the UK economy, and yet it has suited City institutions. I want to see the voice of the true owner expressed in these areas. Actually, if I look at the people who are giving evidence to you, I do not think you have got a single true owner giving evidence to you. You have always got intermediaries. There is a sort of hankering element. I hope I am not giving the impression that I think all progress is retrogressive, but I cannot, for instance, persuade myself that high-frequency trading is a good thing and that we would all be worse off if it had not been invented.

Q106 Mr Walker: Coming on to M&A, we have looked at evidence that described the Cadbury-Kraft deal as a disaster for the UK. You yourself have said that this is something that is undermining the position in the UK. Do you think that your recommendations, when you put out your report, should have been different in the light of the M&A we have seen? What would you have changed?

Lord Myners: I was a younger man, and my views have hardened. I said very little about M&A in my report, other than to point out that most M&A transactions do not deliver the outcomes that are suggested. I have subsequently gone on to say that the Takeover Code is rather like the British guns in Singapore in the Second World War: they were pointed in the wrong direction. The Japanese invaded not from the sea but from the Malay Peninsula. The Takeover Panel largely focuses its attention on the shareholders of the target company, and not on protecting the interests of those in the acquiring company, who are often subject to serious value destruction as a result of the egos and hubris of

company executives. I wish I had been more critical of takeover activity.

The problem, Mr Walker, is that the prevailing sense throughout most of my career in the City has been that takeovers are good because they sort out badly performing businesses. If you do not run your business well, it will be taken over, and the new people will run it much better. That has suited the intermediaries. It has suited the investment banks, the stockbrokers, the fund managers, the lawyers, and the accountants. They, in turn, have persuaded the regulators that this was good, but the actual evidence just does not support that conclusion. In fact, takeovers on the whole fail. We should have a warning rather similar to that on a packet of cigarettes on the sort of takeover documents that you and I have worked on in our careers: "This type of activity tends to destroy value."

Q107 Mr Walker: Surely the logical extension of what you are saying is that this is, in many ways, a call for greater shareholder activism, which is a point you made.

Lord Myners: Yes.

Mr Walker: Would you say that, therefore, you ought to have the acquirer having a vote amongst their shareholders as to whether they should be going ahead with deals, rather than the target voting whether they should be taken over? You might see more shareholders speaking up against deals.

Lord Myners: That is correct. However, the problem there is that we have had one or two examples—I can think of two in the last 20 years—where shareholders in the bidding company have persuaded the board not to proceed with the bid. I guess G4S might be the most recent example. It is quite a nuclear solution, because there is a fear that, if you say to the board, "We do not support your recommendation," you are effectively saying that you do not have confidence in the board, and the shareholders do not want to lose the management necessarily. It is a rarely exercised option.

Another issue that we have here, Mr Walker, is that most of the institutional investors who come before you will say, "We don't like being made insiders. We don't like to give up our right to deal. We love dealing. If we are going to be made insiders, we only want to be made insiders for 24 hours." The right approach, used by the activist investors that you refer to—and I am involved with an activist fund—is to say, "We relish the opportunity of being insiders. We would like to be insiders. If that means we can't deal for a month or so, that's neither here nor there if we get the chance to have a voice."

However, most of our institutions do not want to be insiders. They do not want to get involved with a company and say, "We really don't think making that bid makes sense. That isn't what we want you to do." Institutional investors should be saying to companies, "We don't want you to diversify. We diversify in our portfolio. You stick to what you do really well." That voice does not, on the whole, get expressed.

I have sat, Mr Walker, on the board of—I think—11 or 12 FTSE companies in my career. I therefore speak with some experience regarding the fact that there is

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very little contact between companies and their shareholders, other than meetings in which the shareholders are seeking information on the company that gives them a possible trading insight. Most of the dialogue between companies and shareholders is one in which the companies speak and the shareholders listen. The shareholders rarely speak back in terms of their priorities. Activist shareholders do that. They are rather like the white blood cells in the system: they are a force for good.

Q108 Mr Walker: That is a very interesting analysis. Obviously, you are speaking both from the perspective of having worked with companies and having worked with an activist shareholder. I would say, though, from my experience, management tends to be rather wary of activist shareholders. They tend to be rather defensive when activist shareholders take a stake in their company.

I just want to move on to the issue of short-term share ownership. Coming back to the Cadbury-Kraft example, about 5% of the company was owned on an ongoing basis by short-term shareholders. When the takeover was under way, that rose to about 30%, and we have seen that in a whole range of M&A situations. It clearly has an impact on the likelihood of M&A deals going through. Do you think there is any way of differentiating between the voting rights of short-term and long-term shareholders, and do you think that is something we should be looking at?

Lord Myners: This is not easy. I was made Chairman of Marks & Spencer three days after the bid by Philip Green and Goldman Sachs. Over the six weeks that it took us to prepare our defence proposal regarding the other option, namely remaining independent, short-term share traders acquired nearly a quarter of our shares. Many of the long-term institutions sold out, with the commendable exception of Standard Life, who absolutely said, "We will do nothing until the company has a chance to speak." Many other shareholders sold out.

The short-term investors have a very different interest. They are not long term. They are not persuaded by an argument that says, "This is actually a really good company that has not been particularly well-managed in recent years. Stick with the company; invest in the future. The company looks after its employees and its customers well," etc. That argument appeals to a long-term owner. It is an irrelevance to a short-term investor who is here today and gone tomorrow.

Some restriction on voting by short-term investors has a certain appeal. However, as Ms McKechin said, the City is rather good at finding ways around these things, through contracts for difference, etc. I am unpersuaded. My key recommendations on takeovers, Mr Walker, are these: firstly, the Secretary of State should exercise far more powers to intervene to stop the level of takeover activity, and to direct companies more towards self-investment.

Secondly, I would recommend that the pace of takeovers needs to be slowed down to give companies more opportunity to put alternatives forward. You can take over a British company in less than 30 days. There is no other developed economy in the world where it is easier to take over a company, and so we

get a bad outcome. Kraft is a huge conglomerate that is not going to be a good owner of Cadbury. Cadbury and its products, people, culture and values will be lost within the enormous business of Kraft. Most of the investors in Cadbury had the choice: they could have invested in Kraft, but they were not invested in Kraft. They were invested in Cadbury. They recognised that Cadbury was superior, and yet these short-term pressures led them to sell out. I would much rather be an investor in an ongoing Cadbury than in a Kraft, a company that struggles to make a profit in excess of its cost of capital.

Q109 Mr Walker: Following up on that, and this area around foreign takeovers: you accused Kay of being almost xenophobic in your opening comments earlier, but you are also saying that there ought to be a greater public interest focus. You are saying that the Secretary of State ought to be being more interventionist in these processes. There are challenges with that. I mentioned to Kay two weeks ago that one of the deals I worked on was the Arcelor defence against Mittal. You had a lot of countries there that were very keen to be interventionist, but at the end of the day, they were brushed out of the way by the overpowering will of the hedge funds and short-term investors, who wanted to force through a deal. Despite the fact you had politicians in France, Luxembourg and Holland jumping up and down about it and saying that it should not go ahead, the weight of shareholders won out eventually. If there were to be some kind of public interest test or some kind of role for the Government in protecting UK companies, how would you say that would work?

Lord Myners: I think that as much damage is done by M&A of British acquirers of British companies as is done by foreign acquirers of British companies. I am not being xenophobic here: I am simply saying that our rules seem to be extraordinarily permissive, and one might sit back for a moment and ask whether it is actually in the benefit of the economy and society, and why we have concluded that we want to make it so much easier to take over companies than elsewhere. Martin Lipton, who is one of the leading lawyers on takeovers in America, told me recently that there had not been a significant successful hostile takeover of an American company in the last six years. We have had dozens in the UK over the last six years.

These things link together. Fiduciary duty would require the ultimate owner and, through contract, the fund manager—whether it be a good activist or another type of investor—to be able to defend the actions that they took on the grounds that they were in the best long-term interests of the beneficiary. It is quite clear that selling out to the highest bidder is not always in the interest of a long-term investor. I think that Section 172 of the 2006 Companies Act needs a bit more clarification as to what is right. Selling your Cadbury shares today to Kraft, rather than saying no and seeing the Cadbury share price fall if Kraft fails, is not necessarily contrary to the interests of the end owner. It is only contrary if you are addicted to market accounting and think that shares are for trading. I would be very happy to take the side of the argument that says, "I would rather have retained my investment

in the old Cadbury than invested in Kraft.” Cadbury was an international company: 40% of its shares were in international ownership. I do not think, Mr Walker, that that argument is ever really given a chance to be expressed now under the rules and approaches that we have for takeovers. We regard shares as things to be bought, sold and traded, rather than having some deeper entitlement and obligation.

Mr Walker: Thank you very much.

Q110 Chair: Just to pick up one point: in your opening remarks, you said that the Takeover Code in effect encourages the speeding up of takeovers. Could you just clarify that point?

Lord Myners: There were number of modifications to the Takeover Code announced. I am trying to see if I can find the evidence, sir, in the Secretary of State’s response. I think it was recommendation 14, in which the Secretary of State lists a number of areas where changes have been made to the Takeover Code, such as the “put up or shut up” period being limited. There is uncertainty around this. It is a technical issue, and I am happy to write to the Committee.

Chair: That would probably be best.

Lord Myners: Having read Kay several times—in fact, it could well be my chosen subject on *Mastermind*—I have still, at this point, failed to find the relevant section. I would essentially say that the fate of no company should be determined in less than six months. Some will say that this will cause tremendous uncertainty, and ask how a company can survive during that uncertainty. They will argue that this must be resolved very quickly. The people saying that are the agents and fee-chargers: the accountants, the lawyers, and the investment banks. We often lose sight of the fact that companies have a heart. They employ people; they have customers; and they have got communities dependent upon them. Those voices do not get heard at all.

Q111 Chair: Isn’t one of the accusations made by the financial services industry and participants against the 28-day “put up or shut up” period that it is not enough time, and that it actually blocks takeover activity? I believe there is a six-month period after that in which they cannot make the same approaches.

Lord Myners: You are absolutely correct, Chair. I have just not been persuaded that this argument that companies cannot be kept under siege for a long time is necessarily the right way to see the issue. I think the argument that companies should not be placed under extensive siege has been used to reduce the period that is available to assemble a credible alternative. When a company receives a takeover, the duty of directors is to carefully evaluate that proposal, but to also evaluate other proposals, including the possibility that the company has in some way or another failed to deliver its true potential to make necessary changes. When I became chairman of Marks & Spencer, we replaced the chief executive at the same time. We brought in a new chief executive, and we gave the shareholders a better option than the one they had previously been given. In the end, for a number of reasons, that is the option that they were happy to support. I would like

to write to you on the “put up or shut up” period. It is quite a narrow area.

Chair: It is quite a narrow area, and your points seem contradictory to a certain extent.

Lord Myners: They are.

Q112 Mr Walker: In the Marks & Spencer case, what happened at the end of the day is the shareholders decided that you were presenting them with a better option. In many cases, that can be the case. So much of what you are saying about takeovers is really a call for more activist shareholders. Shareholders should be voting with their money, putting their money where their mouth is, and—if they believe in the long-term future of the company—should be willing to buy the shares away from those short-term investors and make sure a takeover does not go through. That is not necessarily an argument for greater Government intervention.

Lord Myners: We have not talked about short-term reporting, or the focus on data, measurement and companies reporting. I am broadly sympathetic with the direction in which Kay goes, although I think he again misunderstands what goes into an IMS. If you have a portfolio that is over-weight Marks & Spencer—you have got more than the index weighting—and along comes Goldman Sachs and Philip Green with a bid and the share price goes up by 50%, and you have got 5% of your portfolio in that, that is a very nice lift to your quarterly performance.

You are quite reluctant to say to the client, “We underperformed last quarter by 0.1%. If we had accepted the Marks & Spencer bid, we would have outperformed. That would have added a quarter-percent to our performance: i.e. plus 0.35% for the portfolio for the quarter. In our professional judgement—which we are happy to explain and defend—it was in your best interest that you retain your investment in this company, given that you are a long-term investor. We do not think the market is of much concern: to the extent that the share price falls after the bid is withdrawn, then we will know more about the company, and we have actually increased our investment in the company.” That is the way a mature and well rooted approach would be formulated, but it is not the way it works at the moment. All of the focus is on short-term performance.

Q113 Chair: That anticipates a question I was going to ask on quarterly reporting. It is proposed that it will be removed, and replaced by “narrative” reporting. Do you think there is a risk that companies will simply stop producing quarterly reports and not do anything about the narrative reporting, or do narrative reporting in such a way that it is totally unhelpful?

Lord Myners: It is quite interesting that, when Gordon Brown was Chancellor, he was very attracted by narrative reporting for a while. He wanted to introduce what he called an “operating review” in annual reports and accounts. In around 2007, he suddenly dropped it without any real explanation as to why he had. I have never asked him why he did that.

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I have sat on the boards of American companies, where there is much more narrative reporting. In some ways, it is harder for the directors to pull the wool over the eyes of the shareholders in narrative than it is in numbers. In numbers, you can fudge all sorts of things. You can put apples with pears and call them lemons, and your auditors may well allow you to do that. It is when you come to express in words what is happening in the company that the directors get quite exercised about their legal liability if their statements are not full, clear and unlikely to be ambiguous.

I quite like the idea of narrative reporting. I think where Kay is wrong, Mr Chairman, is that the IMS issued by most companies is a single page. It does not say very much.

Q114 Chair: Coming on to that, what do you think should be the standard elements in a quarterly narrative report?

Lord Myners: You might start off by saying to the directors of the company, "Let us assume that you are a non-executive director on a board. You probably own no shares, or very few shares, in the company in practice. You attend board meetings one day a month, and you have got other things that you are doing, so you are not very busy. Let us assume that, by some act of fate, you have suddenly become the owner of the whole company. You, the independent director, have now become the owner of the whole company. However, you also have multiple responsibilities, which means that you can only meet with the management once every three months, and you can only afford them 10 minutes. What would you want them to tell you in that 10 minutes? What would you want to know in that 10 minutes? You are the owner of this business in perpetuity. You cannot sell the shares—you are not much interested in the share price, because there is not a share price—and you only have a short period of time. What would you want to know about the company in that 10-minute meeting every quarter? Write that down, and then compare it with what you tell your shareholders, and try to reconcile why there is such a huge difference between the two."

Q115 Chair: That is a very interesting way of answering the question. Since we only have a very short period of time, could you very succinctly say what you actually think should be in them?

Lord Myners: I think you would want to know about the long-term health of the business. I would want to know: "What have you done, during the three months, to make this company stronger?" I would want to know about customer relations. I would want to know about employee relations and supplier relations. I would want to see the company in its network, essentially, rather than in isolation. I would like to know what you were doing in terms of investment in research and development. I would probably like to know the five things you have done in the last quarter that you are most proud of, and the five things you feel you have made a hash of. That might push it for 10 minutes, Chairman. A brief financial schedule with a focus on how much cash the business has generated

and how that cash has been spent would be sufficient for my purposes.

Q116 Chair: Thank you. That is helpful. I would now like to ask you about something that I have difficulty in understanding, which is "asset allocation asymmetric information". In the introduction to your review, you said, "A particular consequence of the present structure is that asset allocation ... is an under-resourced activity." Can you just explain that to me as a layman?

Lord Myners: There are two different issues. There is asymmetry of information: everybody is trying to get the same information. Our approach to efficient markets has been that, if everybody has the most up-to-date information available and they all have the same information, then we get efficient valuation of companies and rational allocation of capital. That has, perversely, restricted the flow of information between companies and their investors. That is why I think that the activist investor who says, "I want to be an insider, and I want to sit on the board of directors," is so much more positive for a company than this widely distributed ownership. The asset allocation model in the way in which Kay uses it is, I think, how a pension fund splits its money between bonds, equities, private equity, property, etc. It is how the fund gets to the optimal point on the efficient frontier of the balance between risk and return. I have spent too much time reading Professor Kay's academic works if I can give an answer like that.

Q117 Chair: Could you just explain this "under-resourced" bit?

Lord Myners: There is an inverted pyramid in investment management, in which the least important functions receive the greatest attention and the highest pay, and the most important function receives little attention and, frequently, no pay. Let me expand on that. Multiple dealers of listed equities in active portfolios who are pursuing what the trade calls "alpha" are trying to out-perform each other. They cannot in aggregate, by definition, out-perform. There cannot be aggregate alpha, so this is a complete waste of time. There is an awful lot of dealing activity in which some will succeed and others will fail. As Kay says, there is very little evidence of sustainability of advantage: this is to say that, even if you have succeeded in the last five years, it is rather like flipping a coin. The fact that it has come up heads five times in a row does not actually tell you that it is going to come up heads next time, but the City seems to work on the basis that it does. This is an area that receives a lot of pay and a lot of attention. Some of the richest people in the country owe their fortunes to this type of activity.

By contrast, the decision on asset allocation for a pension fund—which is about understanding what your optimal level of risk is, creating a risk budget, and then saying that you will invest X percent in bonds and Y percent in equities—is taken by trustees who are often unpaid; who are generally not professionals, or particularly economically knowledgeable; and who are led by the nose by consultants. The most important decisions are taken

by the people with least economic incentive and interest in the outcome, little reward, and little experience. On the other hand, the decision that adds no added value at all is hugely rewarded and in receipt of intensive scrutiny 24/7.

Q118 Chair: That is very helpful. Kay actually seems to think that developing this concept of fiduciary duty may help in making that asset allocation more efficient. Do you agree with him?

Lord Myners: I do. I think anything that makes clear where responsibility lies would be advantageous. Kay and I were aligned on that. Kay, if he read this transcript, would probably say, "Paul, you were very unfair, because there is much more that we have in common than we do not." I would agree with that. I might have sounded coruscating in my comments on Kay, but I just wanted to make sure that you do hear that there is an alternative view to the one that I think most people are going to give you over the next few weeks.

Chair: Thank you.

Q119 Mr Walker: That is a very helpful clarification. One of the things that you and Kay seem to agree on as well is the complexity of the intermediary chain between companies and the equity markets, and you commented that that has been becoming steadily more complicated since the 1960s. Kay has said he thinks that is a problem for the market. Is there any way we can change it? Is there any way that complexity can be broken down?

Lord Myners: I think an informed group of trustees would begin to look at how many people are eating off this carcass. We have got the guards, the guards of the guards, and the guards of the guards of the guards, and in a low-inflation, low-economic growth environment, the amount of investment return that is being absorbed by unnecessary fees is, in my view, quite high. I have made it quite clear to the Committee that I am a keen supporter of activist shareholders. I believe that activist shareholders, if they do their job well, are really a force for creating good and strong companies. I find myself much less persuaded that the hyper-dealing activity of algorithmic trading, etc, adds value. I think one of the things that should happen here, Mr Walker, is that the trustees of pension funds should be much more questioning about whether there is a different way to do things; whether they need to be paying all of these fees; and whether they are convinced that they are getting value for the fees.

Q120 Mr Walker: Is there an issue with the structure of the sell side—the intermediaries—and the way that has changed, particularly since the Big Bang and the shift towards a trading mentality that is transaction-based rather than relationship-based? I think I asked this question of Kay: is there any way of turning the clock back on that? Is there any way of having a more relationship-focussed set of intermediaries who are going to be talking directly to those investors and developing long-term relationships with them and with the companies?

Lord Myners: I have never been convinced that the so-called "sell" side is the optimal way of providing

a bridge between investors and companies. If you speak to most companies, they say they would like to have long-term investors with whom they can have a sustainable, continuing dialogue and relationship. They would like to have fewer shareholders, so that they have fewer people to meet. The standard for a chief executive of a company is that, twice a year, they announce their results, and then they spend four or five days, meeting 10 institutions every day, in London, Edinburgh, New York, Boston, and San Francisco. They would much rather only have a couple of shareholders to meet, or four or five shareholders. They would prefer to spend longer with them, rather than have an adviser looking at their watch and saying, "It's 10 minutes to the hour: we have got to be moving on."

The model in which we have a huge number of shareholders, and where the bridge between the company and the shareholder is often through the form of a sell-side analyst, seems to me to perpetuate that constant movement in ownership. The sell-side analyst makes their money from transactions, Mr Walker, as you and the Committee know. The company says they want to have a stable, long-term shareholder base. Yet, when they communicate with their owners, they often do it through the use of a sell-side analyst whose own economic model is predicated on the absolute reverse, which is an ownership that changes every hour.

I think there is an opportunity. The transactional approach that Kay has identified as being very different from the old model has been a global phenomenon, not just limited to the UK. It is not easy to reverse, but the right way to change it is to be clearer as to the deficiencies of the current model.

Q121 Mr Walker: You have been quite critical of Kay for not suggesting more specific things that could be done. We can be clear about the deficiencies, and we have been very clear in our analysis of what the problem is, and I suppose that a financial transaction tax could potentially be part of that solution. Are there any other practical changes that you think could deal with that culture of very complex and aggressive intermediaries who are effectively pushing a transaction model?

Lord Myners: He who pays the piper calls the tune. The problem has been that the person who pays the piper has been somnolent, and has expressed no particular preferences for any type of tune, or even the quality of playing. He who pays the piper is the trustee of the pension scheme. In that area, I absolutely remain on rock-solid ground with my own review on institutional investment, which could be summed up as saying that the pension fund trustees have just got to get smarter and be more on the ball. That is a source of change, Mr Walker. Achieving that is more important than anything else, but I think that areas like fiduciary duty, an investor forum and more disclosure are all helpful. However, it is getting the trustees as close as you can get to the ultimate owner, which in most cases is the director of the investment company or the trustee of the pension scheme, to ask more fundamental questions about whether there is a better way of doing this.

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What we have seen in the Kay Report is that public companies and the public company ownership model, as we currently know it, is not producing good economic outcomes. I will come right back to the beginning: is there anything in Kay that is going to enhance the performance of the UK economy, and lead to greater and broader prosperity and a stronger society? I do not think there is anything in Kay that is going to make any significant progress in that direction. We need to keep focussed on that core aim and ambition.

Q122 Mr Walker: Just one more question, if I may. You talked about the position of the pension fund trustee, and their motives are very clear: they want to get the best return for their pensions, which is very worthy. You yourself have talked about sovereign wealth funds and the role that they can play, and you have talked about the more concentrated ownership they can provide and the fact that sometimes they will be investing in private companies, rather than just public ones. Is there not a concern, looking from a UK plc perspective at sovereign wealth funds, that their motives may not be quite so transparent? Their motive, rather than simply being to get a good return for their shareholders, may be something more than that: something political, or something about access to resources when a sovereign wealth fund takes a stake in a company. Is the role of sovereign wealth funds not something that other investors ought sometimes to be a little wary about?

Lord Myners: That is another very good question. The taxonomy of sovereign wealth funds is very broad and complex, and it is therefore quite difficult to generalise. Some sovereign wealth funds undoubtedly have a quasi-political objective. Other sovereign wealth funds have actually eschewed that, and are almost frightened of appearing to be too engaged as owners, through fear that they will be accused of seeking to exploit extra-territorial political influence. One has got to look at it case by case. I could list those sovereign wealth funds that I thought were more politician and those that were less political, but, as you can imagine, I could not possibly do that in a public forum.

Q123 Rebecca Harris: Good morning, Lord Myners. As someone with no prior background in this area, today has been an education for me. I am delighted that this inquiry looks to be a lot more engaging than the rather dry one that, I confess, I was expecting. Thank you. My first question is: could we, or would we, be able to use pay and remuneration to try to incentivise a better alignment between shareholders, fund managers, directors, and the wider public?

Lord Myners: I am sure there are plenty of dry sessions to come. I use the word “alignment”, which is a word that intermediaries quite like. Increasingly frequently, fund managers now put on company directors the same objectives by which they are themselves rewarded. The fund manager is told by his client, “We want you to out-perform the index over rolling three-year periods,” either a broad index or an industry-specific risk. So what do the shareholders do?

We need to always be clear about the difference between a shareowner and the fund manager.

The fund managers then try to put similar obligations on the company chief executive, and the board directors are told that their bonus is dependent upon how well the share price does over a rolling three-year period. The fund manager feels under a short-term performance pressure, and so they absolutely replicate that in the arrangements put in place for company bonuses. It is not surprising, therefore, that many companies say they feel under great short-term pressure. Academic evidence shows that, when asked in confidential questionnaires—admittedly, in America, but I do not think it is necessarily different here—company directors say that they would probably cut back on research and development that they really thought would produce good results if that would enhance their share price. We have got an alignment that is the wrong sort of alignment. We have got an alignment around a common interest in short-termism.

If we go back to my model of where I would be if I suddenly found I had inherited the whole company, I would be much more interested in saying to the chief executive at the end of that conversation, “I think you have done a good job. I like what I hear, and I am going to make a judgmental decision because you are building a good, long-term company. I am just not interested in short-term performance.” But at the moment, Ms Harris, I think the alignment has been around enforcing short-termism, rather than the reverse.

Again, under this fiduciary responsibility, the shareowners ought to be asking whether putting the chief executive under a cliff-edge pressure not to underperform the index over a rolling three-year period really creates great companies. There is a profound belief that the market values companies correctly at the beginning and the end of the period, which I think is deeply questionable. If you underperform the index over a rolling three-year period, you will get no bonus, or very little bonus.

So what does the chief executive do? The chief executive gets out on the road. He tells the story of the stock. He re-levers the balance sheet. He buys in and cancels shares. He does an opportunistic M&A bid about which he can talk positively for a short period of time before it becomes evident that the bid has not worked, in which case he is then on a treadmill of doing another one. We have reinforced a short-term focus through remuneration, which is very distinct from the behaviours that you see in true long-term, great companies. These are frequently unlisted. Some of the best companies in the world are either unlisted, or are listed and have a significant anchor shareholder who focuses on the long term and not the short term.

Q124 Rebecca Harris: Professor Kay specifically recommended that performance incentives for company directors should be shares, held at least until they have retired from the firm. That makes sense to me, as I come from a small family firm: from my perspective, that is how business always was. What do you think about that?

Lord Myners: Conceptually, it is rather attractive, but it is wholly unenforceable. Logically, you would sell your interests through derivatives. You might leave the company in order to be able to sell. There is a point, Ms Harris, where a director can actually have too much of their wealth invested in the company. They become too obsessed with the share price.

Most of the people I truly admire in business are not motivated by money alone. Most of them are motivated by wanting to create great companies. Kay makes some very interesting points about ICI and GEC. He contrasts how they used to be with how they became when the City got a grip on them. Look at banking: when I was a young man, to be director or regional director of Barclays Bank or Martins Bank was not a recipe for making huge amounts of money. You were well off—you were a prosperous and respected member of the community—but you did not have private jets and all of the things that Mr Bob Diamond and others seem to have ultimately been motivated by. If the only way you can keep your management team is by paying them more and more, then you probably have not got the right management team.

Q125 Rebecca Harris: It is not necessarily about paying them more money; it is about paying them in the long term. Is the point not that your rewards are a long way away?

Lord Myners: I can understand that, but I might reverse it. I might say that it is not the fact that your rewards should be a long way away; it is the fact that your vision should be to the longer term. Are you doing things that will create a better company in the long term? One of the other problems we have in remuneration is that most of these remuneration agreements are now very formulaic. They are based on things like total shareholder return, etc, and weak and lazy directors have come to rely upon formulaic decision-making rather than exercising judgment. A really good board of directors would look at it and say, “Madam Chief Executive, we think you are doing the right things. We think you are creating a stronger company with a significant future. The stock market does not necessarily agree with that at the moment; we are not much concerned with that. We know more. We are going to give you a reward that we think is appropriate to the value we think you are adding long term.” That is not the way it works now. Thinking long term is important, but I do not think that thinking long term necessarily means that the disbursement of the reward should be long term.

Q126 Rebecca Harris: It is just that I can see the attraction. You realise it is many years down the line, and if you have not made sure the company is in good health for the future, then it does not work for you.

Lord Myners: It is rather romantic. You can say that you cannot realise these shares until your retirement, but the fact is that most of us are not in wealth-accumulation mode when we get to retirement; we are in wealth distribution mode. It would be odd to live on a modest income until the age of 60, and then suddenly have wealth beyond the dreams of avarice

dumped on you as the reward for 40 years of loyal service. I somehow do not think that would work.

Q127 Rebecca Harris: We have already covered quite a lot this morning about short-termism. You and Professor Kay might agree on the need to adjust the timescales in which success is measured for asset managers. Is there anything you would like to add on that, in terms of getting extra clarity?

Lord Myners: Most asset managers would welcome anything that encouraged them to believe that their clients would support them over a longer term; that their clients were less focussed on the very short term; and that their clients were less focussed on how they did against the index. One of the terms that you hear in the fund management industry is “tracking error”. Tracking error is how you measure the extent to which a portfolio deviates from the index. Most active—as opposed to activist—fund managers monitor very carefully the extent to which there is a risk of them markedly deviating from the index.

Most fund managers regard themselves as in some ways enslaved by this, and would say in their true hearts that they would rather be able to run a portfolio with a higher tracking error. This would deviate from the index over short and medium time periods, but would produce superior long-term returns because it held fewer investments and was a more concentrated portfolio. Kay and I are both in favour of more concentrated portfolios. However, Kay does not get to grips with these things. He talks about the benefits of concentrated portfolios, but does not ask, “Why is this happening?” He does not seriously explore why portfolios are so substantially diversified, which is disappointing.

Q128 Rebecca Harris: I was going to ask you a question about FTT, which you largely covered in your discussion earlier with Paul Blomfield. You were very convincing on the benefits of this as a means of reducing short-termism, but how would you counter the argument that this is simply a tax on pension funds, and another point at which there is feeding on the carcass?

Lord Myners: The primary purpose of tax is to raise money to support programmes approved by Parliament, but there is a secondary function of tax, which is to achieve what are judged to be economically or socially beneficial outcomes. My thesis would be that a sensibly constructed FTT would actually be of benefit to pension funds. That is to say, it would calm down the excessive trading and deal-making that represents a significant cost to pension funds. In an environment in which trading was significantly diminished by a sensibly constructed tax, the net cost of the tax would be lower than the net gain of excessive trading. I come back to my core observation here, which is that hyperactive trading can add no value. For every winner, there is a loser. It is not even as good as that: if there were a winner for every loser, then there would be no disadvantage. There is disadvantage, because every trade bears a cost. There is what is called a bid offer spread between the price at which people will buy your shares and the price at which they will sell them on, which is

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leeching money out of the system to the benefit of intermediaries.

Q129 Chair: Thank you. Just moving on, and trying to pull all of your comments together: you conducted your own review. We have had Kay 10 years subsequently. Kay has made a lot of recommendations in theory, although there are issues about how robust they are, and exactly how they involve some sort of positive action by the Government. Given the experience you had when you did your report 10 years ago, and looking at Kay and his recommendations, how would you beef up those recommendations to actually achieve the sort of ends that you and Kay are broadly in agreement on?

Lord Myners: A number of Kay's recommendations are very much motherhood and apple pie.

Chair: I described them as such, too.

Lord Myners: They are good—I do not dissent from them—but they are not going to happen unless there is more of a forcing mechanism. The key in the report is that the fiduciary responsibility obligation potentially has the ability to be more of a forcing obligation. The Government's response to Kay was very vapid. I could not really tell from reading it whether the Secretary of State was punching the air and saying, "This is just what I wanted: this is going to make the change that I want," or whether he was saying, "This is another thing I can cross off my to-do list until I get called in front of Mr Bailey and his Committee." I have a slight inclination that it was more of the latter than the former.

I think that the Secretary of State has really missed a point on this investment forum, Chairman. He should have said to the investment industry, "I am going to invite three people to set up a group to tell me how this forum is going to be established. I am going to get them to set out what the options are. I am going to get the industry signed up, and I am going to give them 30 or 60 days to get that done." As far as I am aware, there has been a lot of discussion and very little progress on creating this investment forum. However, I am confident that by the time they come to talk to you they will have done it, because I fingered them for not making progress. On M&A, there is a single sentence from the Secretary of State that says he is going to look at competition policy and mergers and acquisitions, and that he hoped to produce something in, I think, early 2013. One of the things I learned as a Minister was that the phrase "early in the year" can, in Government, apply to anything up until 30 June.

Chair: We have found the same.

Lord Myners: Reports produced for the summer, as well, can often stretch well into October or November. I would like to have seen Dr Cable get much more involved and engaged here than he has done, and I still think that there is an opportunity for him to do that. I have nothing else to add, Chair. I think Kay has got a beta-plus for this report from me.

Q130 Chair: We could probably second-guess the Secretary of State's position on this for quite a long time, but it could be that Kay was set up to give recommendations—to do the work and make the

recommendations—to provide the basis for a policy initiative by the Government. It has not really delivered on that. What would you put in to actually give the Secretary of State something to say in terms of, "We have got the evidence. These are the recommendations. I believe that we should go forward on them"? At the moment, he has not really got those recommendations to go forward on.

Lord Myners: Having authored a number of reviews, I have become familiar with the process under which the review team prepare the report with the reviewer. They then pass it from their left hand to their right hand, and they draft the Secretary of State's response to the review team. I have never seen a review in any department of state in which the Secretary of State has said, "This has fallen lamentably short of what I had in mind. I wanted something that was going to address the vandalism and the speculative damage done to British business, etc," which Dr Cable was talking about before he came into government and, indeed, after he came into government—in September 2010. It would be refreshing if at some point the Secretary of State were to say, "This report does not get as deep into the issue as I would like."

What would I like the Secretary of State to do? I would like the Secretary of State to say, "I want a more fundamental understanding of whether public companies are providing a good purpose. I would like to really understand why institutional investors do not seem to regard themselves as owners of businesses. I would like to understand why there are so few people in fund management who have any practical experience of business management. I would like to question whether the idea that fund managers should talk to companies about strategy, organisation and incentive would actually be testing them on issues where they have a competence." Most fund managers have not done anything other than work in the City, in fund management. They have never run a business. I am one of a small group, Chairman, of maybe not more than two dozen people who have had some serious City career experience on both sides of the table. If I were sitting down as the Secretary of State with Professor Kay, those would be the sorts of questions I would be asking. I would say, "John, this is what I really need to find the answer to." The first five or six chapters of John Kay's report are an academic book on market efficiency and agent-principal conflict of interest. It could well be that Professor Kay was not asked questions with sufficient clarity.

Q131 Chair: You talked about being on both sides of the table. Could you just put yourself in our position, and be on our side of the table here? We are doing an inquiry. We want to make recommendations. What sort of recommendations do you think that this Committee should be making to the Government?

Lord Myners: I would almost like you to recommend that the Secretary of State go away and do this exercise again, either with Professor Kay or with somebody else. I would like you to say that there are questions that Kay has only analysed on the surface, and not asked deeply enough.

Chair: That is what Lord Adonis says.

Lord Myners: If you want to stick to saying, “He is not going to do that, Paul; let us just stick with Kay has produced,” I would pick out three or four things in the Kay report and say, “I want urgency about these. I want urgency about the investment forum and about fiduciary duty. I want to completely look again at the issue of how companies communicate with shareholders.” It would be good if the Secretary of State spelt out in as much detail as possible that his summer 2014 review will be a serious review, rather than a review conducted by officials who would say that everything is broadly alright and that we are going roughly in the direction that Kay set out. He should say, “I am going to staff this up properly.”

I would also come back, Chair, to my point that the Secretary of State could have got a grip on the recommendation about the investor forum. He could have said, “There will be a way found to fund it through a £1-per-deal contract note tax,” which, as I said, goes to pay the fees of the people who are seconded to the Takeover Panel. That would set a good precedent there. If this investor forum is a grouping together of trade associations, it will absolutely support the continuation of the status quo, and will move at the speed of the slowest ship in the convoy. You need an investor forum that combines serious and committed spokespeople on behalf of the ultimate asset owners—the trustees and directors of investment funds—with some people from the corporate side of the table as well.

Q132 Chair: The first problem with another review is that it would be seen as Government indecision. The second thing, of course, is that it could well come up with conclusions that were just as inconclusive as the Kay review. You have outlined some positive steps that we could take as a Committee. It does seem to me that there is a very real dilemma for Government here. It does not want to get in a position of regulating the industry, with huge potential unforeseen consequences, but it has to find a way of making those participants act in a more responsible and long-term manner. I think, generally, there is a consensus about the sorts of principles that should be involved in doing that. Who do you think should be responsible for trying to ensure the compliance of asset managers, asset brokers and company directors? It seems to me that one way of doing this is to have some sort of body that would actually exercise some monitoring influence and, potentially, control over these people.

Lord Myners: If we emphasised the fiduciary responsibility, it would ultimately be a matter for the courts. If trustees or directors were failing, then they would run a risk of challenge from those who have placed them in a position of trust. I look at bodies like the FRC and the new FCA and somehow, Chair, I cannot convince myself that they are going to be able to make much change. The FRC, I think, is in a

comfort blanket of believing that its stewardship code is making any real difference. When you speak to most company chairmen and chief executives—and I speak a lot with those people—they say, “Has the stewardship code changed? Are things fundamentally different and better?” They do not really see any change, but the FRC is able to say 200 fund managers have signed up to it and it is all terribly good. If there were clarity about fiduciary duty, the courts would be the ultimate enforcer.

To just go back to the early part of your question, I do not think it would be a failure or a U-turn for the Secretary of State to say, “Quite frankly, this report has asked lots of questions. Kay set out what the issues are. Where he has not done as well is in coming up with practical solutions. Having identified half a dozen key questions, I want to ask why this is happening and what can be done, and I need another report that comes up with very practical solutions, well rooted in understanding of the real world.” Bear in mind that Professor Kay is a very nice man, but he is an academic. I think the only business experience that he had was when he was on the board of part of what eventually became HBOS. I think, maybe, one might say, “Let’s hand this over now to ladies and gentlemen who have practical and real experience.”

Q133 Chair: I think that concludes our questioning. Can I thank you? It was a longer session than I think we anticipated, but it is also fair to say that it has been more entertaining and illuminating than we perhaps anticipated. You have given us a body of comment and evidence that we may well be able to recycle in our questions to asset managers, Government, and so on. Can I thank you very much for that? I say this to all witnesses, but it is perhaps more appropriate than normal in your case: we may well, on examining your evidence, feel that there are further questions that we would like to ask. We will write to you, and we would be grateful for any reply that you could give. There was, of course, the issue of the Takeover Code and the 28-day “put up or shut up”. If you could provide us with further information on that, that would be very helpful.

Lord Myners: Chairman, may I also thank the Committee for giving me as much time as you have? I am very grateful to you for that. When I read the transcript and the numerous places where I have failed to explain myself clearly, I will write if I think that might help you. I do describe things, Chairman, with a degree of passion. I really do believe very seriously that there are things here that could be a lot better. I would ask your Committee to point us in a direction, bearing in mind the test of: “Will the economy be better?” That is the starting line, and I do not think that Kay has quite met the test. Thank you very much for your time, Chairman, and the Committee

Chair: Thank you.

Tuesday 26 February 2013

Members present:

Mr Adrian Bailey (Chair)

Paul Blomfield
Caroline Dinenage
Julie Elliott
Rebecca Harris

Ann McKechin
Mr Robin Walker
Nadhim Zahawi

Examination of Witnesses

Witnesses: **Catherine Howarth**, Chief Executive Officer, FairPensions, **Christine Berry**, Head of Policy and Research, FairPensions, **Simon Wong**, Visiting Fellow, LSE and Partner, Governance for Owners, and **Dr Paul Woolley**, Head of the Paul Woolley Centre for the Study of Capital Market Dysfunctionality, gave evidence.

Q134 Chair: Can I welcome you here today? Thank you for agreeing to share your thoughts with the Committee. Can I also apologise for the slight delay in starting? We had quite a lot of urgent business to get through before we started this session, but we will crack on. I know who you are, but for voice transcription purposes could you introduce yourselves and the organisations you represent?

Christine Berry: I am Christine Berry, Head of Policy and Research at FairPensions.

Catherine Howarth: I am Catherine Howarth, Chief Executive of FairPensions.

Simon Wong: I am Simon Wong, a partner at Governance for Owners and I also hold appointments at the London School of Economics and Northwestern University.

Dr Woolley: I am Paul Woolley, a senior fellow at the London School of Economics.

Q135 Chair: I will open the questions. Can I make it clear that some will be person-specific and others will be to the panel? Obviously, that does not preclude anybody from speaking on a question directed at somebody else if they feel they have something to add to or subtract from it. Equally, if somebody else has said what you agree with, do not feel that you have to repeat it. I am conscious that all of you have been prolific contributors to this debate, and we are limited in time, so try to keep your responses as short as possible.

If I can start with a question to Dr Woolley, you have written a lot about the myth of market efficiency. Do you assign the rise of financial intermediaries and institutional shareholders to be a cure for market failure or a cause of it?

Dr Woolley: The main cause is that we have a misunderstanding of how finance works. The prevailing paradigm of market efficiency, which has been with us now for 40-odd years, is deeply misleading. It says, as you know, that prices reflect their fundamental value, that markets are selfstabilising and that competition ensures that agents do not earn excess profits. That has not been apparent for the last 20 years.

Moreover, the theory of efficient markets has informed the actions of everybody to devastating effect. It still informs the actions of investors and intermediaries, but also of the regulators. We know that markets are not efficient, but we are using all the

metrics, analysis and prescriptions of a dud theory, which is only a special and limiting case. What happens is two effects of the fact is that markets are not efficient. I can explain more why they are not efficient, but that will take a bit longer, so I will skip it. The two consequences of inefficiencies are first, that assets are mispriced and we get the potential for bubbles and crashes, and, secondly, that the agents are in a position to capture excess profits. The combination of the two is devastating and has caused the size of the finance sector to balloon and to do its job, which is simply a utility function, very badly.

Q136 Chair: I was going to ask you if you could explain why it is a dud market—I think those are the words you used. I am a bit nervous in view of the time you said it would take to explain it. Could you summarise it in perhaps 40 or 50 words?

Dr Woolley: The efficient market theory assumes that investors invest directly in securities, but they do not; they delegate to agents. The investor does not know if the agent is competent or diligent. That is the heart of the problem, and it is called asymmetric information. The investor does not know these two important facts, and that is the cause of all the problems. What I and my colleagues have been doing for the last several years is providing an alternative framework for analysing markets that presents a general theory rather than a special and limiting case of market efficiency. We assume everybody acts in their own self-interest and in a rational framework—they seek to maximise profits and do the best job as they see it to invest to achieve the best riskadjusted return—and that they are not stupid or do not have behavioural biases. They may do, but the point is that by assuming rationality we can provide an alternative framework that explains all the mispricing. It goes a long way to explaining all the various market failures and phenomena that have not been explained by a theory that assumes that everything is perfect to start with. It is like natural science, where in physics you continue to assume that there is a perfect vacuum or zero friction. You have to relax those assumptions, and that is what we do. We show how it is that markets go wrong. If you can show how they go wrong you can make a good stab at the solutions.

Q137 Chair: I am a layperson in this. Would it be fair to say it presupposes that the investor has the level

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of knowledge and expertise and will act in a rational way, whereas in fact the investor delegates that role to the agent, who may be acting not in the interests of the investor but in the interests of the agent?

Dr Woolley: Who owns the capital? We all, in our private capacity, are the owners of capital. Because we are operating on the basis of a false understanding of how finance works—because theory does inform the general understanding—we have been delegating in the wrong way. That includes the pension funds that act on our behalf, because they are agents as well and have their own interests, as well as the pure agents—the fund managers, brokers and investment banks. But the key to solving the problem is to have a better understanding of how finance works and fails, which involves the simple step that I explained of introducing delegation, and seeing the implications of that. Then we can start to sort things out. We can show those who are responsible for investing the assets of the man in the street how they need to change the way they delegate and the strategies they need to embrace and those they need to ensure are avoided.

Q138 Chair: Do you think that the Kay proposals meet that challenge?

Dr Woolley: No. We have been worrying about the issue of short-termism essentially for 40 years. We have never addressed the problem properly, because we have not got to the key issue. They have all been good descriptions of what goes on and good seat-of-the-pants responses, but you need a new analysis and a new framework for understanding finance. Without that, you will never get anywhere.

Simon Wong: To develop further the discussion on the agency issues and lack of knowledge, regulation equates size with sophistication, so if you manage a pension fund you are considered to be a professional investor, and as a result a certain set of assumptions goes with that. That is quite false. You see that people who are managing these large pools of money are being outmanoeuvred by their agents purely because they do not have the sophistication to understand what they have purchased and what they have been told. There is a big issue there. You see reforms in different parts of the world to try to improve the governance of pension funds and enhance the competence of the people running them, whether they are trustees or people within the pension fund vehicles. The lack of knowledge contributes to the expanding chain of intermediation. You do not know, so you get advice. You might retain other consultants to assist you in your task.

Having said that, I do believe in aggregation vehicles. I do not think we should go back to the days when retail investors made all the decisions. I do not think they are in a better position either. Around the world, in places like Canada and Australia, you see efforts to build scale in pension funds, whether they are defined-contribution or defined-benefit plans. With scale comes greater resources to hire staff and attract people to be governors, and greater access to alternative asset classes, which might be better aligned with the time horizon of pension funds, for example real estate or infrastructure. You might also have greater leverage vis-à-vis your asset managers, so that will bring down

costs. That is just one aspect of the agency issue that it is important to stress.

One other aspect, which may not have been given sufficient attention in the debate, is conflicts of interest. There has been great effort in recent decades to disclose and manage conflicts of interest. We should also stress the importance of avoiding conflicts of interest to start with.

Catherine Howarth: To build on both those sets of remarks, delegation to investment professionals is obviously inevitable in a system of pension savings nationally. What is missing, we feel, is accountability, transparency and opportunities for those whose money is invested by others on their behalf to scrutinise what is done. What is perhaps missing from Kay's recommendations is things that bring the whole debate right back down to the saver whose capital is at risk and who has to trust others in this system. At the moment, there are very few mechanisms for them to access information, for example about how votes have been cast on their behalf. There are very few expectations or practices for pension funds to provide succinct narrative reports about how they have exercised stewardship on behalf of savers, as is expected at the next link down in the chain. Companies are encouraged to provide to shareholders succinct narrative reports on what they do, but agents do not have to provide that kind of quality of succinct information to savers on whose behalf they act. In our system at the moment, there is a big democratic deficit and a big opportunity to begin to overcome some of these agency problems. I certainly do not disagree that we need a new theory of finance, but in practice we need to overcome those problems by making sure savers can hold their agents to account and see what they are doing on their behalf.

Q139 Chair: At our previous hearing, which you may well have followed, Lord Myners commented that technology had impacted on the way the market worked and that we had a transactional-based process. Do you think that in a way that is inevitable, and that the issues you have highlighted hark back to a perceived golden age of democratic accountability and transparency and we will never go back there?

Catherine Howarth: I do not think there has ever been a golden age in this respect. One of the important transitions we are undergoing in pensions is from defined-benefit schemes, where individual savers could sit back and relax because they had a guarantee at the end of the day, to a situation now where they are fully exposed to the investment risk, and it is absolutely essential we have mechanisms to enable scrutiny to take place. Most pension savers are busy and preoccupied with their lives and do not have the time to undertake detailed scrutiny, but, just as in a parliamentary democracy you have a small number of citizens who take the trouble to scrutinise what is done by their representatives, similarly you could have a very small number of people in a workplace pension scheme who undertake that scrutiny and look for reporting from the scheme about how stewardship is being undertaken on their behalf. We do not imagine that everyone is going to get involved in this, but, unless people have rights to information about what is

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done on their behalf, the agents are free to act in any way, and that is a big part of the fundamentally poor health in the system currently.

Q140 Chair: That is an interesting suggestion. I do not want the rest of the panel to comment at length, but broadly, would the other witnesses be in agreement with those comments? Yes, good. Professor Kay did say, “‘The market’ is simply some average of the views of market participants. ‘The market’ knows nothing except what market participants know.” Do you think we have attached too much power to the market, and what has been the consequence? This is a question to the whole panel, and if comments could be kept brief I would welcome that.

Christine Berry: When you say “too much power to the market”, do you mean market participants or the idea of the market as a whole?

Chair: Yes.

Christine Berry: The point Kay makes that companies should concentrate on developing relationships with individual shareholders rather than with ‘the market’ is certainly true. The idea of the share price and the market as the thing around which all the players in the system calibrate their behaviour, even if that is not in the interests of the people who the system is supposed to serve, either the companies or the savers at the end of the chain, is certainly part of the problem. And—in a while I suppose we will come on to our work on fiduciary duty it is also part of the problem with the way intermediaries see their duties.

Simon Wong: The belief that prices in the markets at any particular time are correct, as we have discussed, is ill founded. Yet it infects regulation and contributes to short-termism corporate pension funds worrying about liabilities expanding over short time periods, and executives being perhaps overly concerned about stock price or overly incentivised with share price-based remuneration schemes. Those are a few examples of how it has impacted the market.

Dr Woolley: If I were to point to one major problem about the way markets function and participants act, it is that the greater part of investment now conducted is based on current and recent price movements rather than fundamental value. There are only two basic strategies of investment: trend following—let’s call it momentum investing—and fundamental investing. That is actually the best way of looking at short-termism and long-termism—to understand that short-termism is not just a short holding period, and long-term investment is not just buy and hold. The important distinction is the choice being made between investing on the basis of recent price movements, ignoring value, and fundamental investing, which focuses on the true worth of assets. Unfortunately, because of our misunderstanding of how finance works, the contracts that pension funds are writing with their agents and the way regulators are regulating, vastly more transactions are conducted based simply on recent price movements rather than fundamental value. Very few steps are required to address that problem and rid the markets of so much momentum trading, or automatic trading if you like. The beauty of it is that to do so would be to the great

advantage of pension fund returns and the ultimate beneficiaries. There is a self-interest.

Chair: That is a very lucid explanation, and we will come back to the measures before the end, but I want to bring in Paul Blomfield, who has some questions on Catherine and Christine’s evidence.

Q141 Paul Blomfield: I want to focus on the three mechanisms you suggest to address the principal/agent problem. The first is that you argue for legal mechanisms to be attached to fiduciary duties. What are the minimum fiduciary standards that you think are essential for regulators to enforce?

Christine Berry: It is important to remember that Kay made two different recommendations on fiduciary duty, one of which recognised that fiduciary duties should be part of the solution to dysfunctional capital markets and that they require intermediaries to act in the best and sole interest of the people whose money they manage. The other recommendation recognised that, unfortunately, too often fiduciary duty has been part of the problem and has been interpreted in an unhelpful and narrow way by people who do possess fiduciary duties. Your question relates to the first of those.

The key difference that Simon touched on between fiduciary standards of care and the standards currently applied by, for example, FSA rules or under MIFID, relates to the avoidance of conflicts of interest. As Simon said, we have spent far too much time worrying about the disclosure and management of conflicts of interest. In theory, the starting point for fiduciaries is that conflicts of interest should be avoided altogether and, if they can’t be, they must be resolved solely in the best interests of the beneficiary. Professor Kay himself made a good analogy in an article he wrote for the *FT* drawing on the recent incident involving a ballboy who covered the ball. Kay made the point that he saw there was a clear difference between what would have been fair for him to do and supporting the home team. In the same way, FSA rules currently require that conflicts of interest are managed and resolved fairly as between the firm and the beneficiary, which is clearly different from resolving the conflict always in the best interests of the beneficiary. Those are clearly two different standards. There have been lots of attempts to conflate that in the debate and to say there is no need to talk about fiduciary duty because the regulatory rules already impose those standards. They do not; it is clearly a different standard. The real value of talking about fiduciary duty is in the context of requiring a higher standard in relation to avoiding and managing conflicts.

Chair: That must be the first time ever the activities of a ballboy at a football match have been quoted in evidence in a Select Committee.

Paul Blomfield: But it is a very good way of illustrating the point.

Chair: Yes, it is.

Paul Blomfield: Catherine, did you want to comment?

Catherine Howarth: No, I am fine with that.

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Q142 Paul Blomfield: The further recommendation you make is that the remuneration of fund managers should be structured to encourage long-term behaviour. Are you satisfied that Kay has addressed that? Knowing intermediaries as you do, how would you implement such incentives?

Catherine Howarth: There are huge risks in trying to be too clever with the remuneration of fund managers. We ought to be able to learn the lessons from having tried to be clever around the remuneration of company directors. Simplicity is best. Paul can perhaps speak more about remuneration of fund management. There have not been particularly complex arrangements, but they are creeping in and there is much more performance-related pay now in fund management. That brings a host of risks because, depending on the time frame involved, it will exacerbate the existing compulsion towards short-term trading in the emphasis of fund managers over long-term stewardship orientation. It is an area where pension trustees potentially are a bit naive and could be more engaged.

I also think that fiddling around and trying to bring in sets of remuneration consultants to advise about the ideal theoretical arrangements for pay in the fund management industry could lead us down the same alley where we try to structure corporate pay in a way that is aligned with shareholders to great detriment. It is undoubtedly important, but I do not think it is the main area for recommendation in trying to achieve structural change in the fund management industry. It is far more important to make sure that pension fund trustees as the clients of fund managers are asking smart questions about the stewardship approach that is taken; the engagement that takes place with company directors about the strategy of the company; the long-term risks facing the company, including environmental, social and governance risks. It is important that reporting by fund managers about their stewardship is available down the chain to those savers whose capital is ultimately at risk, who depend upon the trustees to do a good job and who ought to be in a position to keep an eye on the oversight by the trustees of the fund manager stewardship of the underlying companies. Part of the challenge here is that there are lots of links in the chain. That is somewhat inevitable, but bringing it back down to the saver is the critical thing.

Q143 Paul Blomfield: Notwithstanding that caveat, in your evidence you did suggest that a different approach to remuneration could encourage more long-term behaviour. Beyond simplicity, what would you recommend?

Catherine Howarth: There is perhaps a case for ensuring that in the way fund managers are remunerated, there could be some emphasis on putting stewardship, oversight and engagement with companies centre-stage. At the moment, many fund managers regard stewardship activity and engagement with companies, which is a labour-intensive process, as just a cost centre for them, whereas that can in fact be some of the most value-adding process undertaken by fund managers. Trying to make sure that it is very explicit that part of the contract for payment for fund

management includes resources being devoted to that by fund management firms makes a lot of sense for pension fund clients.

Christine Berry: In terms of our taxonomy of ways in which you can address the problem, we talked about remuneration as one of those. On reflection, I would broaden that to call that category “incentives”. Remuneration is one incentive that fund managers are faced with, but it is not the only one. There has been talk in the oral evidence already about the other ways in which pension funds incentivise their asset managers. We gave the example in our written evidence of fund managers who were sacked during the dotcom bubble because they did not invest in tech stocks, so they were underperforming in the short term even though that was clearly a prudent decision in the long term. That is an incentive. Government also provides incentives through the tax system and regulatory regime, so in looking at how we can align incentives better in the chain we should not just fixate on remuneration. There are a range of other relevant tools as well.

Simon Wong: I would certainly second that. I have been speaking to large pension funds around the world as part of research I am conducting. The largest pension funds are looking to streamline their asset manager relationships. They want fewer external asset managers but deeper relationships, so they want to get to know them better and establish a strong basis of trust.

Certain remuneration practices would be helpful, one of which is to have fund managers invest in their own funds so they have skin in the game, so to speak, or to pay fees based on multiple-year performance. I also would like to warn against certain ones. I have seen in passive mandates that the fund manager is rewarded only through the securities lending revenues that they generate. Imagine the misalignment that creates, because that fund manager has much less interest in the value of the fund going up: rather, that person will be more interested in how much securities lending revenue he can generate through that relationship. There are certain things that I would advise against strongly.

Dr Woolley: The key is for the right contracts to be written in terms of the guidelines, benchmarks and risk parameters. Then the remuneration side of it will take care of itself. Once you make sure that fund managers are focusing on fundamental value and are given the appropriate benchmarks, not market-capped weighted benchmarks, and all the risk parameters are sorted, you eliminate most of the momentum trading and the trouble we have with ridiculously high rewards.

Q144 Paul Blomfield: Can I return to Catherine and Christine on the question of consumer pressure? That is another area you focus on, and you say it should have a greater role. You recently wrote in “The Missing Link” about the disconnect between savers and those who manage their money, which is obviously what we are talking about today. How specifically do you think policy makers should address that?

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Catherine Howarth: There are a number of different mechanisms. At a very simple level something we have been advocating for a long time is mandatory disclosure to savers of voting by fund managers who have been delegated those powers by pension funds. I emphasise that most savers are not going to be leafing through the voting disclosure record of their pension fund, but having that information available in the market will allow very valuable opportunities for comparison between funds. It will ensure that fund managers casting those votes know there is a potential to be scrutinised and that interesting controversial votes will be picked up, and that does happen. Some disclosure is going on; it is best practice and is in the stewardship code, but it is very far from the level that would really raise standards across the market as a whole. That is one simple mechanism.

Coming down to the pension fund level, as part of our work at FairPensions we engage a lot with individual pension fund members who are interested in getting answers from their schemes about what is going on and how their money has been invested. They have virtually no rights to information. Some funds do disclose what holdings are held on behalf of the saver and how votes have been cast, but they do not have to. Similarly, although funds are required to disclose whether or not they give account to environmental, social and ethical factors, they do not have to give any account about how that was undertaken, so the opportunity for a fund member to take a view on whether these stewardship functions have been exercised on their behalf diligently and intelligently is extremely limited. Quite small regulatory interventions could be introduced to ensure that information in the market exists and the scrutiny function can be undertaken, which should improve behaviours right through the market.

Q145 Chair: You referred to fairly small regulatory interventions. In a few words could you just summarise what should be done to realise this?

Catherine Howarth: We have long advocated improvements to the disclosure regime for pension funds so they have to give an account of how they exercise stewardship and voting and engagement activity on behalf of scheme members. In the same way that there are calls for company directors to provide succinct narrative reports on forward-looking risks, that is absolutely what pension funds should also be doing for their members. I am a pension trustee and I sit on the board of a scheme that works hard in this regard. Nevertheless, it would focus our minds, and those of pension trustees all over the country, if we knew we had to provide a succinct narrative report detailing the forward-looking risks to the investment portfolios, how they have been managed and what fund managers are doing effectively to manage those risks for the long term. That is where long-termism can start to be hard-wired into the system in a helpful way.

Q146 Paul Blomfield: Can I move on to the stewardship deficit that you have talked about and Simon has written about? Can you describe the

problem as you see it and whether Kay has addressed it?

Simon Wong: I alluded to it in my earlier remarks. It starts at the top of the investment chain. I disagree with the Kay report in the sense that it places excessive reliance on asset managers to drive things forward. The asset owners need to step up in terms of how they monitor the asset managers and the type of investment management agreements they reach with their asset managers. It really starts from that.

There are issues, which I have written about, of whether as an asset manager you have the capacity to monitor properly. If you have a portfolio of hundreds of stocks, can you properly understand each one? My argument would be: no. There is scope to reduce portfolio size in terms of the number of holdings. For example, why would a pension fund need to be invested in 700 companies in the UK alone to feel properly diversified? Academic evidence says that the benefit of diversification tapers off at 20 to 50 stocks, provided they are not all in the same industry, of course. There are issues in terms of being able to monitor companies properly and become a stronger steward.

There is also the issue of skill set. Two weeks ago Lord Myners alluded to the fact that fund managers might not have such a deep understanding of how companies are run. If you are going to engage, do you have the right people with that sort of corporate-type background?

Last, how will they be rewarded for it, or how will the costs be borne? I have written previously that in some funds the costs of engagement are shared between the asset manager and the fund he manages. Those are different aspects that need to be addressed in order to improve stewardship.

Q147 Paul Blomfield: Is there also a question of resources in terms of companies not being prepared to commit sufficiently?

Simon Wong: Exactly. There is the issue of whether you have the right skill set. Do you have the right people who can engage with companies with credibility? Are they sufficiently senior? Do they have a deep enough understanding in terms of what is going on and the complexities of running a business? Presently, people would probably argue that on the institutional investor side you may not have the right personnel in all cases to undertake this type of engagement.

Paul Blomfield: That is helpful. Thank you.

Q148 Mr Walker: One of the Kay recommendations supported by the Government, which was also very strongly supported by Lord Myners in his evidence to us, was the idea of creating an investor forum. FairPensions has been a bit more sceptical about that, saying it is unclear how this initiative will differ from previous and existing investor bodies. Some of the evidence we have just heard suggests that might even entrench some of the problems, with the focus on asset managers talking to themselves rather than necessarily to their shareholders. Would you care to comment on that idea and whether you think that

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could make a difference? Is there a way of setting up an investor forum which could improve the situation?

Christine Berry: There are a few points to make about the investor forum. The first is what it would have to look like in order to be effective. It would need to include representation from asset owners as well as asset managers; it would need to be not just another vehicle dominated and run by the trade associations, which would be very similar to the vehicles we already have. To be fair, that is a view shared by many people who are involved in trying to set up the investor forum. It is not completely clear at this point whether it will ever get off the ground, and that is something worth bearing in mind when making a wider judgment about the extent to which some of the more voluntaristic elements of the Kay package are likely to be successful in the medium term.

It is also important to be clear about the limitations of what an investor forum would and would not resolve. My understanding of the reasoning behind the investor forum and its creation is that it was intended to deal with some of the collective action problems particularly created by the dispersion of ownership, excessive diversification and the fact that any individual shareholder would own only a very small proportion of a company. Clearly, enabling investors to act collectively would be very helpful for that specific problem, but that does not mean it is the silver bullet that will solve some of the underlying structural problems we have talked about in terms of the relationships between asset owners and asset managers, the way those players are incentivised, the excessive diversification that itself leads to this problem in the first place and so on. I hope that is helpful. The investor forum would be useful if it happened in the right way. It will not be the silver bullet that fixes all the problems in the market.

Q149 Mr Walker: Dr Woolley, you talked about the dysfunctionality in the markets. Do you think this would help with that at all?

Dr Woolley: Yes, absolutely. We have to learn the new code of behaviour that needs to be followed. You need a forum to help promulgate this new approach. It is very significant that in the last couple of weeks the G30 has come up with a proposal in its report on long-term finance and economic growth. The first of the five proposals is for a new code of best practice for large funds. That is a huge step. We have never had anything like that proposed. The implication is that currently there is malpractice. It is saying that there should be a new understanding and a new instruction manual. Everybody is using an instruction manual based on this efficient market hypothesis, and we need one that recognises the best benchmarks, risk parameters and contracts with agents. It has to be a complete revolution in the way delegation is handled, and a forum would play a valuable role in educating the asset caretakers. It is not just a UK problem but a global one, and it should be handled globally.

Q150 Mr Walker: Is it not rather optimistic to assume that a forum that is likely to be dominated by the asset caretakers or their trade bodies, as has been

suggested, will come up with a revolution? Is it not more likely to try to entrench the status quo?

Dr Woolley: No. If one rewrites the understanding of finance, one points to the way that funds can in their own self-interest, irrespective of what any other fund does, adopt these strategies and policies. There will be a very significant early mover advantage to funds. If you get the G30 coming up with a code of best practice and some of the sovereign wealth funds and big public funds start adopting this, members of pension schemes in the UK could say to their trustees after a year or two, "Look at the returns you are getting and the returns that the sovereign wealth funds are getting. Why is there a difference?" They can challenge trustees. It replaces a silly herd with a sensible herd.

Q151 Mr Walker: If the forum is structured in the right way. I am interested in the point you make about having asset owners represented in the forum. How do you think that could be achieved?

Catherine Howarth: It is already partly the case that a number of the very largest UK pension funds have staff dedicated to working on stewardship issues—corporate governance experts and so on—so there are resources that they can contribute in terms of personnel or helping to fund the activities of an investor forum. Making sure that asset owners contribute to that would be a very good thing. The point has already been made that to take on a company over a sustained period about a problem you have identified as a shareholder is quite resource-intensive. Given that you own only a very tiny fraction, everyone who owns shares in that company will benefit if you secure an outcome through your engagement and dialogue. It is very sensible to look for a way that asset owners of shares in a given company can share the costs arising from an intensive engagement with a company on a long-term risk. All of that makes sense. It would be really good if we had contributions from individual pension schemes to the costs of running the investor forum. They would then take quite a close interest in what it got up to, and that would be a good thing.

In a way, a trick was missed in the Kay report in not emphasising enough the role of asset owners in taking the initiative on this. There is very strong emphasis on asset managers. The asset managers are critically important agents, and we do need to think about their behaviours, but they are not the ones with the incentives to move this situation along; asset owners are. Asset owners themselves would focus more on the problem if they had to give an account to the underlying members of how they were resolving these issues.

Simon Wong: I completely agree that asset owners need to play a central role. A broader point is that we have a lot of small pension funds in the UK. What do we do? Ontario, for example, has issued a proposal to consolidate asset management to build scale among smaller pension funds. There are steps in that direction that could be extremely helpful. I know this is beyond your remit here.

In terms of the investor forum, it is important for it to have dedicated resources and to come to an agreement

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with existing shareholder bodies that they would perhaps adjust or reduce their activities to avoid unnecessary duplication. That might mean they should be represented in some form in this new forum.

One of the key objectives is to attract the involvement of foreign investors. That is a laudable objective, but we should temper our expectations because of the following: for foreign investors, the UK may be a small market relative to their other holdings, or they may see the UK as relatively well governed and as a result they want to allocate their limited resources to other markets. We should also think about the practices they bring with them. In continental Europe there is probably greater sensitivity to environmental issues and human rights. In the US there is a more permissive stance on executive remuneration. So it is also about the standards that investors bring when they come to this forum.

Q152 Mr Walker: That is very important, and I think colleagues will all want to touch on the issue of foreign investors. I want to touch on one other Kay recommendation around executive incentives. We have talked a lot about the incentives for asset managers and intermediaries. One of the recommendations of Kay was that executive incentives should be provided only in the form of company shares to be held until at least after the executive has retired from the business. There are some concerns about the practicality of that. Do any of you have any views on that idea and suggestion? Is that something on which there could be legislation?

Dr Woolley: No. That is a rather long horizon for an individual. If we have a code of best practice for longterm investors, corporates will start to act in ways that reflect that. They will start to recognise that dividends are the only way the investor gets his money back from investing in shares; they will start to recognise that buying back shares when the price is high is not a sensible thing; they will start to invest for the future and take a longterm view. Just as there should be a code of best practice for investors, similarly there should be a code to show managers what best practice is, not just on research and longterm projects but also on the financial structure and retention ratios to wean them off the short-term focus.

Catherine Howarth: It makes a lot of sense to let the new regime on executive pay that is now going through Parliament bed in. Much more important than further tinkering with executive pay is all the stuff I talked about earlier on which we focused in our report "The Missing Link", which is enabling those at the bottom of the chain who invest the capital, take the risk and delegate to other people to oversee executive pay to have some kind of scrutiny and accountability of what is done in their name. In that area, where there has been very little focus, there are real opportunities to advance the debate. If fund managers know that they are being watched in the way they cast their votes, they will pay more attention, and if they are being explicitly mandated by their pension funds to have conversations and cast votes with an eye to the longterm value of the underlying corporate entity when they are thinking about remuneration, all those

are positive things. Further tinkering in terms of regulation is probably not going to take us forward.

Q153 Rebecca Harris: I want to go back to the governance of pension funds. Mr Wong, you wrote an article saying that it was the missing link in the Kay review. Lord Myners told us of the possibility of resourcing and equipping pension funds as well. What would we need to do, from your experience, to make that happen?

Simon Wong: At present Canada has an interesting proposal, which is to mandate the transfer of assets from smaller pension funds to a new vehicle as a way to build scale. These are defined-benefit plans, so asset allocation decisions will still be made at the pension fund level. But at least you will have a collective vehicle that hopefully will give you better scale and help reduce costs. Where you have decided to retain external managers, it would give you greater leverage. These are steps in terms of how we bring together smaller funds.

A big topic in different countries is who should sit at the top of pension fund organisations. Increasingly, people are coming to the view that the well meaning person on the street is perhaps less and less suitable for this role, and you need senior people with either business or investment expertise because investment has become that much more complicated. Without addressing the quality of the people at the top, both in terms of the trustees but also those in management, you will continue to have problems with an extended chain of ownership, meaning excessive reliance on investment consultants or the use of multiple layers of fund managers either because you do not have access to certain products or you just need advice.

Another benefit of scale is that, instead of just buying products off the shelf, you are in a better position to say, "Can you please design something that would fit my particular needs?" I hope that answers your question.

Q154 Nadhim Zahawi: I have been listening very carefully to the very useful contributions. Dr Woolley talked about eliminating momentum trading and looking at fundamental investing. That is a good point, but, to get rid of the short-termism, on the side of the corporate you go before your investment community at prelims, interims and so on during different periods, and you are judged on that short-term performance. Therefore, that is the driver of human behaviour. Pension fund managers themselves are judged on short-term performance because of their league table. Is not the problem a cultural one in the sense that my parents and their parents have got used to pension returns that are just unachievable? The problem lies there rather than with all the issues around governance. They are all good things, but is there a cultural problem in that we have got used to unrealistic returns on our pensions?

Dr Woolley: Not at all. We enjoyed lush pensions in the 1980s and 1990s for special reasons, mainly because equity and bond markets were so cheap at the beginning of the period, but we can expect a little more than the 1% per annum real that we have had for the last 12 years. It should be possible to earn on

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diversified assets in pension funds more of the order of 3% or 4% per annum real. Part of the reason it is not 3% or 4% real is the cost of the finance sector, which probably amounts to between 1% and 2% per annum real taken off your pension for having it managed—the hedge fund costs, brokers and the whole caboodle. It is also the fact that the way the finance sector is currently structured and its size means it is prone to crisis, and that imposes a huge cost on the economy. As we have seen, in the UK 15% has been knocked off GDP in the last four years. In a steady state, if we get back to global growth of more like 3%, we should look for a return similar to 3% real, but beyond that you should be able to add 1% or 2% on top of that as an expectation. The target that pension funds should aim at is a benchmark of something like real growth of global GDP plus local inflation.

Q155 Nadhim Zahawi: But do the rules of the game allow the pension fund manager the time and the room to say, “I am going to stick with this management team because they are investing for the long term; they may not deliver the returns in this or the next quarter, but I will stick with them”? I do not think the rules of the game allow the pension fund manager that leeway.

Dr Woolley: I agree, given the way the game is played. The point is that, as I said at the outset, we do not understand how finance works, and we have a discredited theory delivering an instruction manual for funds and regulators that causes them to engage in short-termism and all the bad things that are so costly to the ultimate beneficiary.

Chair: What it comes down to is that the purpose of this inquiry is to see where we can change the rules of the game to realise long-termism. Catherine, did you want to respond? If you could keep your remarks brief that would be helpful.

Catherine Howarth: At the moment about 11 million people in the UK are saving through workplace pension schemes. That is about to grow by about 8 million more people through pensions auto-enrolment. We need to get this right, because a very large number of UK citizens are going to be committed through auto-enrolment, often without making a very active choice in that direction, to this system where their hard-earned money will be committed to agents in the hope they will look after it well. While returns in the future—who knows—may not be as juicy as they have been in the past, that is all the more reason to try to get these conflicts of interest in the system ironed out and ensure the beneficiaries get the maximum possible benefit from the system. Good governance, oversight and scrutiny—all the things we have been talking about—are essential components to getting that right. This may lead back to the conversation about fiduciary duty, which is really about trying to make sure that the saver is absolutely at the heart of the system.

Simon Wong: There is a cultural issue. Part of the reason asset managers are obsessed with short-term relative return is that their clients focus on that, but do the clients really understand what they are buying? A UK pension fund trustee admitted to me last year,

“We look at benchmarks because that is the easiest way to measure performance. It is much harder to understand the capability of the asset manager and the strategy being pursued.”

That is where governance needs to change. If you look at the Australian Future Fund, they explicitly stress that they do not look at “peer risk” and how their asset managers perform over the short term. They look at 10-year rolling returns or three-year rolling downside outcomes, so it is a very different way of assessing performance. Some of the larger pension schemes are looking for fewer but deeper asset manager relationships so they can better understand them.

Q156 Rebecca Harris: How do pension funds differ in their structure and governance from other players in the equity market?

Catherine Howarth: There are important differences between trust-based pension schemes, whether they are defined-contribution or defined-benefit, and the insurance side of the pensions market, which has grown rapidly, where individuals have a contract with the firm. One of the issues about which we have concerns is that the standards of protection and the focus on the sole interests of the saver are a bit weaker on the insurance side than the trust-based side of the market. That is one important difference. There are real variations among pension schemes. Some are very big and do their own asset management in-house; they have their own fund managers and hold shares and trade them directly themselves. Most delegate to asset managers so they have various mandates and contracts for equity investing and bond investing and so on. The evidence is that where pension funds take some of that stuff back in-house and manage it themselves, they produce excellent returns and save a lot of costs. One of the reasons they produce good returns is that the costs are lower and high costs eat into returns in a very damaging way. That is a point well made by Kay in his report.

Christine Berry: One of the important differences between trust-based pension schemes and most other players in the chain is that they are generally non-commercial and not-for-profit entities that exist purely to serve the interests of the saver. One thing often forgotten, whether it is in the debate on executive pay or on Kay, is the fact that a lot of the entities we are talking about, whether it be asset management firms, insurance companies or whatever, are themselves listed companies that are subject to all the same pressures we are talking about in relation to listed companies generally. That is why asset owners, particularly large not-for-profit trust-based asset owners with good governance, are the players in the chain who really should get a lot more focus than maybe they have in the debate on the Kay review previously and are the ones with the potential to shift the system. They have more of an incentive and less of a disincentive to shift the system.

Q157 Rebecca Harris: Dr Woolley, to go back to short-termism, clearly we need to extend the period of time over which the performance and the portfolio of individual traders are measured and compensated. You said at the outset that this was an issue that we have

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failed to get to grips with for over 40 years. As the Chairman said earlier, this Committee is trying to get solutions, so can you help me with practical solutions about how we align those incentives as policy makers to make it happen?

Dr Woolley: In a written submission yesterday, I set out seven steps that needed to be taken. To summarise those, it is to educate the asset caretakers. One uses the term “asset owners of the pension fund”. They are not the owners; we are. They are the asset caretakers. We have to educate the asset caretakers to show them that they are pursuing strategies that are causing the returns to be severely reduced. We need to show them the steps they need to take to change to a stable long-term cash flow-based benchmark with risk metrics, and we need to write contracts that focus on long-term performance and, accordingly, fees based only on long-term performance. From the regulator’s point of view, they should recognise that they should not impose these short-term mark-to-market valuations that are coming in. They are trumping every attempt investors might make to be more long-term. If you are focusing just on what the value is in a year’s time you will be forced back into a short-term strategy, so the regulators need to be educated as well.

Q158 Ann McKechin: Professor Kay was quite passionate about the need to abolish quarterly reporting obligations. Dr Woolley, you have mentioned looking at a three to four-year period as the average time over which people should be looking at investments. Do you think that one measure would be of real help, or would people find another way to get back to the same culture we have at the moment?

Dr Woolley: I understood that John Kay was talking about the quarterly reporting of companies. I see no merit in reducing the information flow. The quarterly reporting of pension fund returns should still go on. My concern is that there should be much more focus on long-term cash flows for the investing funds. The point is that, if you focus on doing the best you can each year in terms of the market value of the fund, it will not give you the best outcome in the long run. The long run is not the same as the sum of the intervening short terms. The way of achieving the best long-term results is to invest on a long-term basis, focusing mostly on dividends and interest payments. The whole strategy should shift. Funnily enough, what are called value managers have been doing very well for their clients, and that is a similar sort of approach, which should be adopted.

Q159 Ann McKechin: Does anyone else on the panel have a different view about the issue of quarterly reporting?

Christine Berry: My understanding of your question was whether, if we abolished the regulatory requirement, people would continue to do it anyway. There is an extent to which quarterly reporting and all the dynamics that go with that are driven not just by regulatory requirements but by shareholder expectations. That dynamic is part of the reason we have argued quite strongly—it is something we have not really touched on today—for clarification of investors’ fiduciary duties. There has been a lot of

hand-wringing over the fact that we introduced duties for directors under section 172 of the Companies Act, which were based on the idea of enlightened shareholder value—that directors should look to the long-term success of their company and should consider wider social and environmental factors—but that does not seem to have had a lot of impact. And all the evidence suggests that that is because you cannot have enlightened shareholder value without enlightened shareholders.

Q160 Ann McKechin: Some people say that part of the problem is that it was so vaguely set out in legislation that the ability to enforce it was practically nil. People just felt they could ignore it anyway. We can prepare legislation, but if it is not sufficiently well defined you do not have the ability to enforce it.

Christine Berry: There is an argument around that and I am sure there are respects in which the legislation could have been improved, but the more fundamental problem is that the way the legislation was explicitly formulated was to go not for a stakeholder approach but enlightened shareholder value whereby, because it is ultimately in the interests of the members of the company, to whom directors still owe their fundamental duty, they should take an enlightened approach.

Q161 Ann McKechin: My final question, which all of you can answer, is: do you think that currently we have the right balance between voluntary compliance and statutory legislation? You seem to be suggesting that we need more of the latter. Does the panel think we have the right balance in terms of making these changes?

Christine Berry: On the specific point of fiduciary duty, we have argued that statutory clarification will be needed. That is not to say we need to impose by regulatory fiat good behaviour, but we need to clarify an area of the law where currently it is thought that the law prohibits good behaviour, which is a real problem. That has gone to the Law Commission. We are supportive of that process. We should not assume that at the end of the process it will be sufficient just for the Law Commission to pronounce, “This is what we think the law is”, and it will change behaviour. That would be hugely helpful, but I am sceptical whether it will be enough. There will be a need for express clarification.

More generally, there is certainly a case to say that there is too much focus on voluntarism at the moment. Kay makes the point, which I think is correct, that you cannot impose regulation to make all these cultural changes, but that does not mean there is nothing Government can do. One of the things Kay says Government can do is set the tone, and one of the ways of doing that is by articulating a willingness to regulate if voluntarism does not work.

Simon Wong: On your last question, I am going to sound like a broken record, but the Government can facilitate the consolidation of pension funds by establishing pooled vehicles and compelling transfer of assets and, correspondingly, providing liability protection to trustees in that respect, which is being proposed in Canada. There might also be scope for

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regulatory intervention in terms of avoiding conflicts of interest. The last thing is the tax regime. People have talked about perhaps lowering capital gains tax if you hold shares for the longer term, but maybe you also want to take away their ability to write off losses in certain respects for short-term trading and so on. There is scope there.

Chair: That concludes our questions. I realise that we have had to hurry you to a certain extent; indeed, we have had to hurry ourselves. If there is further

evidence you would like to give to the questions you have been asked, or questions that have not been asked but you feel should have been, please feel free to write to the Committee to submit that. Similarly, if we feel that there is a question we should have asked arising out of the evidence you have given us we will write to you and will be grateful for your courtesy in replying. Thanks very much indeed. I am sorry we have had to hurry you a bit.

Examination of Witnesses

Witnesses: **Dominic Rossi**, Global Chief Investment Officer, Fidelity Worldwide, **Anne Richards**, Global Chief Investment Officer, Aberdeen Asset Management, **Harlan Zimmerman**, Senior Partner, Cevian Capital, and **Roger Gray**, Chief Investment Officer, Universities Superannuation Scheme, gave evidence.

Q162 Chair: Good morning and welcome to the inquiry. Thank you for agreeing to give evidence to us. I do understand, Harlan, that you have a problem with your throat. We appreciate your fortitude in coming before a Select Committee and trying to speak to us, but if it does become a problem, feel free to back out of this session and we will rearrange for you to address the Committee at a future date. I would stress that we do want to get full value from your contribution today and if you have physical impediments to giving us that then it will be better to leave it to another day.

Can I just ask you to introduce yourselves and the organisations that you represent, just for voice transcription purposes?

Roger Gray: I am Roger Gray. I am the Chief Investment Officer for USS. My title actually goes Chief Executive Officer of USS Investment Management Limited.

Chair: That is the Universities Superannuation Scheme.

Roger Gray: Correct, which is the pension fund for the university sector for primarily the academic staff. There are about 300,000 members and about £36 billion; it is the second largest pension fund. Relative to the previous discussion, we are in that rare category in the UK of being large enough to have a large inhouse investment team and therefore a significantly reduced proportion of intermediation.

Anne Richards: I am Anne Richards, the Global Chief Investment Officer of Aberdeen Asset Management. We are a listed company on the London Stock Exchange. We manage around about just shy of £200 billion for external clients, which will be a mixture of pension funds, institutions and private retail investors, both in the UK and a considerable proportion of our clients are overseas.

Dominic Rossi: I am Dominic Rossi, the Global Chief Investment Officer of Fidelity Worldwide Investments. We manage approximately \$300 billion, of which about \$175 billion is invested in equity markets around the world.

Harlan Zimmerman: I am Harlan. This may not work, because of my throat—it sounds a bit like garbage collection testimony in New York. It sounds much worse than it feels. I will leave it to you whether we should continue. I am Harlan Zimmerman, Senior

Partner, Cevian Capital, which is the largest dedicated active ownership investor in Europe. We are long-only. We have only approximately 10 to 12 companies at a time. The average holding period is four to five years. We manage about €7 billion.

Q163 Chair: Thanks very much. I would reiterate if you do feel that you cannot speak anymore, feel free to back out and we will arrange for you to come again. I have a couple of opening questions. This is to Roger Gray. You included a copy of the letter that you sent to Professor Kay during his review. Why was that and did you feel that you had not had adequate consultation with him? Do you feel that the concerns that you expressed have been addressed by Professor Kay?

Roger Gray: That is quite a wide open question. Ours is one voice. We believe that, as an end investor, that voice probably had some standing and indeed is generally heard in the market. It is not universally held, so no umbrage if not all of our views are incorporated in his conclusions, but I would say that the letter is there as much to show that we are actively engaged, as an end investor, with any consultations to do with the workings of the financial system and how it plays to the interests of long-term investors.

Q164 Chair: Do you feel that organisations were sufficiently consulted by Professor Kay?

Roger Gray: It was a tough ask, and one of the reflections on the nature of the pensions industry in the UK is that there are not very many of us who have the dedicated resource to respond to inquiries such as this. We have a team of five professionals in responsible investment. There are a handful of other funds that have one or two individuals so dedicated, and then it runs out. So if the voice of pension funds has not been heard through us or through the trade organisation, then that is as much a reflection of the structure of our industry as it is on the endeavour that he undertook.

Q165 Chair: That is an interesting observation because, from my perspective as, obviously, a contributor to pension funds, it is a bit worrying that there are, shall we say, inadequate resources in the

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industry to respond constructively and positively to the inquiry. Is that a fair reflection of what you said?

Roger Gray: That is a fair reflection, yes. There is a high degree of fragmentation in the UK. There are certain markets in Holland, Canada or Australia where there is more concentration and you have a stronger representation of that pension fund group in the ownership of domestic stocks and somewhat different governance arrangements arising from that.

Q166 Chair: You also said to Professor Kay that “there are likely to be different solutions to the agreed problems.” Now, given the fact that we are trying to hold an inquiry to come to an agreed solution to agreed problems, what exactly did you mean by that? In effect, what would your solution be to what I think are generally agreed as the problems?

Roger Gray: I do not think there is a magic bullet and I do not think there is one clear regulatory or legislative solution to this. It is going to be built up from a number of contributions. This inquiry, the Kay inquiry, the Stewardship Code, the increased attention to corporate governance and the responsible investment more generally that has built up post the financial crisis are all good stuff pushing in the right direction. The question is: will it actually help, or will there be unintended consequences if one pursues with too much emphasis any one of these tracks? I would encourage a broader front rather than a single silver bullet, which I do not believe exists.

Chair: I am now going to hand over to Julie Elliott to ask some questions of the whole panel. I would emphasise that there is no need for every member of the panel to contribute an answer if it does not add significantly to, or indeed subtract from, what a previous speaker has said.

Q167 Julie Elliott: I think that means keep it short. Ten years ago, 15.3% of UK shares were held by individuals. In 2010, that figure had fallen to 11.5%. In your opinion, what are the reasons for this continued rise in institutional investment?

Dominic Rossi: The first point is obviously that equity markets have not performed very well, and in any market that has disappointed with its returns the activity of the individual investor is likely to fall. Subsequently, I do think that if equity markets were going to recover you would see an increase in that participation. But obviously is it likely to be just that factor? I suspect not. I suspect that the intermediation structure that we have and that has grown over the course of the last 10 years or so is part of the reason as well.

Anne Richards: I would add that people have been working in an environment where they have been saving less and borrowing more, and it is a net effect from that. If you are borrowing a mortgage to buy a house, you have choices. You do not just have the option of putting your money into the equity market. You can put it into property and other sorts of assets. In a world where people have been tending to direct more of their savings towards building property, one of the consequences of that is that they put less into equity markets. That is also a factor.

Harlan Zimmerman: The other factor is there has been an obvious breach of trust. It would be difficult to pick up a *Financial Times* today and not find an article about an august British listed company for which the man on the street would think, “What are these people doing with my money? Paying themselves too much, playing with LIBOR, buying companies here and there, paying billions of dollars of fines in America for all sorts of institutionalised schemes that have been found to be corrupt.” If you are the average man or woman on the street, it is quite obvious that you would begin to consider whether these sorts of institutions can be trusted with your money.

Q168 Julie Elliott: With the increasing presence and responsibility in the equity market, have you perceived any strengthening in the regulation of institutional investors?

Anne Richards: If you look at regulation and how it has evolved over the last 10 years or so, there have been some things that have worked well and some things that have not worked well. The things that have worked well have been around principle-based regulation. It came under some pressure for failing to prevent some of the flaws in 2008 in the financial sector, so it is not a solution to everything. But look at some of the things that I think have worked very well—I would draw your attention, for example, to the treating customers fairly regime. It is not prescriptive in the detailed implementation of rules and regulations around treating customers fairly, but the concept is easily understood. It has forced all of us in the investment management world to take a step back; for every action and step along the way, whether we are dealing in the institutional or in the retail space, which is quasi-institutional, it has given us a very good and timely reminder to consider the effect of any action we are contemplating on continuing, exiting and new customers. I speak for our own business, and that is probably true generally across the industry. That is now a very well embedded concept and it has worked well.

Where regulation has not worked well is when it has drilled down into detailed complexity and attempted to, in a sense, micromanage some aspects of the market. In fact, increasing that complexity has made the market—and I use “the market” in its broadest sense—more difficult to gain transparency on and more difficult to manage. As an example of that, I would say the increasing requirement upon many of the agents in the food chain themselves to seek external advice has dramatically increased the number of agents in the chain and has not ended up with us having a better and more effective chain. For example, for the individual who is now required to take advice from an independent financial adviser on their pension fund, the pension fund takes advice from actuarial consultants and investment consultants. They have their asset managers who then manage the money on their behalf. We invest in companies who, in order to get the remuneration reports right, use remuneration consultants and so on and so on and so on. That is an example of where an attempt to micromanage has not

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ended up with a more robust regulatory regime, even though the rules are many times more prescriptive.

Dominic Rossi: The question offers the opportunity to endorse one of the comments on regulation that Professor Kay makes in his report. This is that, with the question of stewardship and the desire to encourage asset managers like Fidelity to engage with companies on board appointments, major investments, acquisitions and so on, that engagement comes head to head against a regulator and a market abuse regime that insists upon uniform information. Within Kay we have an agenda that is entirely different from the one that the FCA is currently pursuing around market abuse. At some stage, we are going to have to triangulate this conversation and include the FSA, because they are trying to sterilise the dialogue between professional asset managers and the companies in which we invest.

Q169 Julie Elliott: How do you—and, indeed, do you—think the UK benefits from the growth of institutional investors?

Dominic Rossi: In the UK alone, we employ 40 analysts and 30 fund managers to scrutinise companies, their management and their corporate strategies before we make an investment. I do not think that would have been possible without the institutionalisation of our industry. Not all asset managers will do this, but we have a very effective corporate governance team that genuinely works with the companies in which we invest to improve their performance and to monitor and, if necessary, redirect their own management incentives. If you consider that asset management has a dual mission—which we do, and I think that is one of the most important conclusions that Kay comes to—first the fiduciary duties to our clients to maximise their returns, but also the stewardship responsibility of improving corporate performance, without the resources of an institutional organisation you would not be able to perform those two. That is not to say that all institutions do perform those two missions, but if you did not have an institutional framework I do not think it would be possible.

Anne Richards: It comes back to the point that was raised in the first session about the information asymmetry. It is not just an information asymmetry but a skill asymmetry between somebody whose day job is quite different, trying to decide, as an individual, whether they think that is an appropriate individual investment or an appropriately risk-adjusted portfolio in which to invest, and the economies of scale, as Dominic has said, that you can gain from a lot of heads who are effectively looking at a particular issue, company or group of companies day in, day out. They can glean much more information from the mass and morass of information that is out there. There are benefits to it in helping bridge that information and skill asymmetry gap.

Roger Gray: I do not know if I should drop this point in, but of course one of the big changes is that the pension fund industry, the insurance industry, in the UK is no longer such a prominent investor in UK equities as it once was. That has to do with the derisking that has taken place and is partly to do with

demographics; obviously in the pension fund industry a lot of defined-benefit pension funds have closed and have matured, which means that they have to take low-risk portfolios. So it is rather stark: where else do you look? We can play a significant role still as investors, but just speaking about my own fund, in the mid-2000s about 40% of the fund would have been in UK equities. That is now about 16% of the fund. Part of that is that we have globalised and diversified our fund, but the institutions that are investing in the UK equity market are now far more diverse in terms of their origin than they were. So the UK-held portion of the UK equity market is much reduced, not just in the retail space, which you alluded to at the beginning of this question, but also in the UK institutional space. If I just choose an asset manager, BlackRock has \$3 billion under management [*Interruption.*] Yes, sorry, \$3 trillion—it's like Austin Powers, isn't it? That is more than the entire UK pension fund industry, of which only a portion and now a much reduced portion is in UK equities.

Q170 Chair: A couple of questions have arisen out of the answers to that one. First of all, Anne, earlier you mentioned that Government are trying to introduce regulation to the detail rather than the broad principle, and you gave an example. What could the Government have done to realise the objectives of their regulation but without having to regulate to the detail that they did? Have you any observations on that?

Anne Richards: The first thing to point out is that it is not all Government-induced. Part of it is regulatory-induced. In part, it is to do with perhaps not joining the dots. It is a fragmented approach rather than perhaps starting from a unifying vision and then working out how that can be taken down. When I talk about a fragmented approach, the sorts of things that I would put into that category are perhaps along the lines of taxation for different types of instruments, which has an effect on behaviour in the markets, and how that taxation is dealt with alongside the pensions regime or the broader savings regime.

One of the things that Government can do to bring about a greater effective change is, for example, by adopting a cross-party and longer-term approach to the overarching operation of the savings and pension regime right across the spectrum. You take away the annual tinkering, for example, that goes on around the rules and regulations of individual savings and pension products. We still have a very fragmented approach in that regard. At a very practical level, moving the savings regime out of the political football to the greatest extent possible, and bringing about a more broadly based and a longer-term vision as to how we might then tackle some of the individual problems that have arisen underneath that, would be a very good starting point.

Q171 Chair: Perhaps this Committee will make a contribution to that process. Roger, there is a particular question I wanted to ask you. You talked about the steps taken to derisk pension funds and take them out of equities into gilts, bonds, etc. Do you feel that, if there had been a better regulatory environment

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that concentrated on long-termism, the need for doing that and the consequential reduction in returns that we had arising from that move would have been avoided?

Roger Gray: Yes. Paul Woolley was referring to some ways in which one could assess whether a long-term investor was indeed doing all right relative to their long-term liabilities. He was saying to look at their income generation capacity, for example, not just the mark-to-market movement in price, and that is an important consideration. Movements in the direction of allowing pension funds to look very carefully at “these are our assets, these are our liabilities; we believe that we are doing all right against them, although the markets do not necessarily agree with that on a snapshot basis” seem to me to be an important dimension of flexibility to get into the system.

All that having been said, the world is a very complicated place and there is real risk out there. The reason why pension funds are suffering at the moment is because there was indeed a financial crisis, and five years have passed and we are still suffering from that in terms of economic progress. Changing cannot get rid of the fact that the pension fund must look after paying its liabilities. Indeed, as I say, there are lots of good reasons why pension funds have derisked; they are not just regulatory ones, but probably at the margin some of the regulatory practices have conduced, or would in future conduce, to behaviours that are not optimal for the long term.

Q172 Julie Elliott: Professor Kay told us that companies tend to finance investment through debt and retained earnings rather than from equity markets. Do you agree with that?

Dominic Rossi: Obviously, over the course of the last 15 years the cost of debt has fallen significantly relative to the cost of equity, which has risen. So if you are a company and you are looking to finance an expansion or an acquisition, debt is going to look like a much cheaper option than equity. On top of that, one has to recognise that the tax code acts as a subsidy through the P and L statement from equity owners to debt. So you have a tax system that incentivises the accumulation and creation of debt as opposed to the creation and accumulation of equity, and then you end up with a financial crisis.

Julie Elliott: That sounded so simple.

Anne Richards: When I started looking at UK equity markets a little over 20 years ago when I started running money, there were close to 1,000 companies in the FTSE All-Share Index and now there are just over 600; the number of companies listed in the All-Share Index has fallen markedly. As asset managers, a lot of us would have sympathy with the view that Professor Kay talked about in his report, which is that the primary function of equity markets is evolving. They are no longer the sources of primary capital. They have become largely the transaction of secondary holdings, and that is their primary purpose. That is quite interesting.

I think the taxation point is an excellent one and I completely agree with that. There is an unequal treatment.

Q173 Julie Elliott: You have really answered this, but does anyone else have any comments? What do you regard as being your primary role in the market?

Dominic Rossi: Also governance. Some companies are publicly quoted in order to protect themselves from regulators, because it gives that check and balance to regulatory involvement. It is not a common answer to the question, but certainly if you ask companies—defence contractors, for example—one of the reasons they are publicly quoted is because they think that the public market gives them some protection.

Roger Gray: Before this Committee, it would be important to say the equity market does some good things. Amidst the noise of the pricing of stocks it does identify winners and losers, and while not always getting it right—who does, particularly when it concerns the future?—that is one of its purposes. Of course, in this context it also gives an avenue for the influence of the owners of that business in terms of the long-term strategy, remuneration and other policies where we think it is important to get the right balance between the end owners and the executive and board.

Anne Richards: We are allocators of capital. In our business that is how we view ourselves. In the UK, our typical portfolio will have between 40 and 50 names in it and our average holding period will be upwards of five years; it is usually seven, eight or nine years. So we regard ourselves as allocators of capital. What we are looking at is where we can allocate capital on behalf of our clients to get the best and most robust long-run return out of that. It incorporates what Dominic talks about in terms of governance. That is a very important part. We do not, for example, have a separate corporate governance team or stewardship team that sits on the side. Our fund managers are responsible for all engagement with the companies in which we are investing, because if we are going to allocate capital to an industry, to a business for a long period of time we want to make sure that we trust the management team to look after that capital appropriately. There is very much that broad allocator of capital view in our role, and Aberdeen is not unique in that. There are other companies that will very much articulate in a similar way.

Q174 Julie Elliott: Lord Myners recently described his report from 10 years ago as a call for action, and Professor Kay closes his report by saying that the task will be long and difficult, but it is time to begin. What will success look like and how do you see the equity market in 10 years from now?

Dominic Rossi: Shall I try to answer that?

Chair: If you can keep it fairly succinct.

Dominic Rossi: Professor Kay’s report was one of the best that I have read on our industry in 25 years. It has been criticised because the recommendations seem relatively light compared to the analysis, but if you ask an academic to produce a report it is going to be an academic report. The analysis that he has put into the industry from a non-practitioner is undoubtedly sound. Where we will hopefully make progress over the course of the next 10 years—and we

do need to make progress—is on the three key issues that he raises. The first is stewardship. Too many asset managers, as I have said already, view their responsibility solely to be that of investment performance rather than also improving the performance of the companies in which they invest. The industry could make huge progress in that role and one way of strengthening that dual mission is to get the regulator to recognise that we, as asset managers, have a dual mission. In all my conversations with the FSA over many, many years they have never asked me once what I am doing to improve the performance of the companies in which I invest. That is the first thing I would suggest.

The second thing is around the whole issue of shorttermism. Everything that you have read around the culture of short-termism is indeed correct. One of the challenges that we, as asset managers, face with respect to short-termism is the persistency of our clients. It is an industrywide problem, but I think the proliferation of intermediation has shortened the persistency of clients in our industry. This means that fund managers are under pressure to perform within a two or three-year time period.

Asset managers used to market directly to the end client 30 years ago, but tend not to today; we have lost contact with the client. By asset managers getting closer to the end client and strengthening our direct relationships with the end client we will improve persistency of assets, and that will have a spin-off in terms of the investment time period.

The third key area is the one of remuneration. I am on record as saying many times that corporate remuneration is too complex and too shortterm. That is also true of the asset management industry. The asset management industry will not be treated seriously in boardrooms until it extends the duration of its own compensation schemes, and we fully endorse the recommendations of Professor Kay on that particular issue.

If we pursue those three issues, I think we will be in a far better place in 10 years' time than we are today.

Anne Richards: It is about trust restored. Success will be that the person in the street has regained trust in the savings and investment industries in general. That trust has been lost to a large degree. I agree with what Dominic has said. I would also add that a focus on outcome rather than process is an important part of rebuilding that trust.

Q175 Julie Elliott: Dominic, you have alluded to the supplementary on this question but I will ask it in case anyone else wants to add. It has been reported that the European Securities and Markets Authority has laid out reform to fund managers' pay. They said that deferred bonuses should be paid out over a three to five-year period, with firms encouraged to consider even longer delays for members of management. The FSA will be consulting on this. How should such a reform be implemented to ensure maximum effect?

Dominic Rossi: Our own view on this is very clear: we should strengthen equity ownership, and the vesting period and the holding period of that equity ownership should be a minimum of five years. Our own scheme is career shares. We own shares in our

company that we cannot sell until we retire. That might be too much of a mouthful for some in our industry, but I genuinely think that long-term equity accumulation really does lend itself to longer-term thinking. I think Kay is absolutely right on that matter.

Q176 Julie Elliott: Would everybody else agree with that?

Roger Gray: It is clearly a balance. Paul Woolley mentioned this previously and I will just repeat it. Someone who is working may have a mortgage and a family and may therefore want to reap some of the reward from what they are doing, and it is about what is the weight that you put on the longterm incentive. A comment on the industry. First, internally we focus on five-year rolling average returns and then we defer some of the bonuses that arise out of that for a further three years. I would call that relatively long term. We do not have shares in our own company; we are not set up for that. One of my comments about the industry at large is that we have sought to engage managers with longterm incentive arrangements, and we have been relatively unsuccessful in achieving that. Particularly in the hedge fund domain, where we thought some humble pie would have been consumed sufficiently to shift that dial, it has been an almost hopeless exercise.

Anne Richards: In the spirit of longer-term compensation I think the direction is absolutely right. One of the things that we are somewhat resistant to is the idea that compensation should be linked in a formulaic way to individual investment performance. I have seen this many times over the years and there is no doubt that behaviour follows incentives, so you have to be absolutely crystal clear what incentives you are putting in place. The approach that we have taken in our business is that the primary incentives we are putting in place are the behaviours that we want. We focus on certain things that are important to us and stewardship plays a part in that and longer-term investment performance is also a part of that, but we are resistant to the idea of making it very formulaically driven because then you start to get investment decisions being driven by the compensation rather than as a reward for it. It is important to make sure that it is a balanced scorecard approach, not just a simple numerical formulaic approach to delivering compensation.

Q177 Ann McKechin: I will turn to the impact of foreign investors and to you, Dominic. Professor Kay's report mentioned the fact that foreign investors, in his opinion, were reluctant to involve themselves in the governance and strategy of UK companies. He did list Fidelity as among the American firms to which he was referring. Has he understood the structure and global nature of you and other international businesses?

Dominic Rossi: I certainly read Professor Kay's comments. I also note that Paul Myners mentioned Fidelity in a completely different light, I am glad to say. I agree with Kay on the issue of stewardship. I also agree with him that the asset management industry is committed to stewardship to varying levels of degree and that this creates a free-rider problem,

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but I completely distance myself from Professor Kay when he wraps the stewardship issue up in a Union Jack. I do not think it is a matter of nationality. I think it is a matter of attitude. The question that all asset managers need to face is: do they believe that part of their role is to improve the performance of the companies in which they invest? We certainly do and we are resourced in order that we can fulfil those obligations.

Q178 Ann McKechin: Can I just clarify one point with you? Are the shares managed by Fidelity classed as UK-owned or foreign-owned?

Dominic Rossi: I remember that question. They will be classified as UK-owned.

Q179 Ann McKechin: That is very helpful. Can I ask all the panel now, in your experience, are Professor Kay's comments and his analysis of the issue of foreign investors in general correct? Obviously, I take Dominic's point about Fidelity, but do you think that there is a growing issue about foreign investment?

Harlan Zimmerman: There is a general issue that proper stewardship and engagement is a cost centre for most investors. There are some exceptions sitting on the panel here, but for most investors that is the case. You do the minimum that you can to protect your investments, which is much less costly than getting involved in 6,000 companies. You focus only on the greatest transgressions and react in a defensive way, and you do the minimum that society imposes upon you. For many foreign investors who do not have the societal pressure here, it is much easier just to vote and do no more. I have been in the asset management industry here in the UK for 20 years or so, back when even the UK institutions often did not vote. Then it became voting with management, if you wanted—you had to vote but you really should vote with management. If you did not want to do that, it had to go all the way up to the top of the organisation. Then it became voting in an educated way, which meant using proxy advisers. We are slightly evolving beyond that, but too many institutions are able to hide behind that and say that because they are voting that is stewardship; because they are writing letters to 14,000 companies around the world that is stewardship. In fact, that is the least costly way of doing something that will protect you from the societal pressures etc.

Q180 Ann McKechin: So it is really more to do with the fact that these companies are global conglomerates rather than being just simply foreign owned, because the vast scale of their business is such that they are not interested in a more direct approach with a company's investors.

Harlan Zimmerman: Do you mean the asset managers?

Ann McKechin: Yes.

Harlan Zimmerman: It is just a numbers game. I would say USS is about the best that exists in the UK, from our perspective, of an engaged owner. If you look even at the numbers there—and it is just five people, I think Roger said—the people there are very

good, but how many companies do they have to look after? There is only a certain amount that can be done, which is why there is all this discussion of trying to outsource this work to the investor forum or something of that nature. Then, as most of you know, and we may come back to this, our point of view is that we are already paying 1,000 people or so in the FTSE 100 to whom we are outsourcing stewardship on our behalf, and those are the nonexecutive directors of the companies. It is they who often do not seem to be doing the job on our behalf.

Ann McKechin: I wonder whether Roger or Anne have any comments on this issue.

Roger Gray: I would like to pick up on that flattering accolade in the air and also accept the point that it is the art of the possible. There are limited resources, and in fact a definition of hell would probably involve all fund managers being hyperactive with all company boards and management, because there are other things to do than dealing with that. Clearly, we all must look to be effective rather than encumbering the companies we invest in or, indeed, snarling up all our resources doing something, so there is a judgment to be made. We vote 92% of the shares that we own, and 100% in the UK. We engage in some close engagements with companies, but I would say the UK will be a larger proportion of those. Our holdings are bigger in the UK and therefore there is more money behind it. We do participate, where it is available to us, with services or groupings such as Eumedion in Holland, which reflect our institutional—

Q181 Ann McKechin: Do you think it is sensible that when a UK company gets beyond a certain critical mass of shareholders who are foreign shareholders there is an impact on the degree of engagement? There has obviously been an increasing shareholding in UK companies held by foreign companies. Has that had an adverse or neutral impact, in your opinion?

Roger Gray: There are forces moving in different directions. The passive industry has grown and it is definitely debatable to what extent they have interest in deploying a lot of resource in terms of active engagement. The concentration of the asset managers, the active ones, does mean that even while the shares of companies are owned by the foreigners, the share register is not getting less concentrated if you look at the asset manager status. I am afraid I do not have a perspective on whether there is a big tectonic shift. We do know that the UK institutional investor voice, the end owner such as ourselves, is somewhat less strong in terms of its ownership stakes than it was.

Anne Richards: I would just add onto that, I see this from both sides of the table because I am an Executive Director of Aberdeen and I do spend time with our shareholders as well. We have quite a significant overseas shareholder base in our own share register and it is difficult to generalise. There are some overseas investors who are extremely engaged, so it is quite variable. What I would say, as it was a very good point that Harlan made, is that we do, to a degree, outsource part of this to non-executive directors. They are there to guard stakeholder interests, and shareholder interests most particularly

within that. One of the more encouraging things that has come up in the last three to four years is that we are definitely seeing much more proactive engagement from chairmen, in particular, chairmen of remuneration committees, coming to us in advance of renegotiating executive pay, appointments of new executive directors, and so on and so forth, having that dialogue in advance of something becoming a controversial issue, and saying, "What do you consider are the key things that we should be looking at and building in?" That is an encouraging trend and we should do more to encourage even more of those non-executive directors to step up to the plate and do that. That is not just necessarily with UK-based investors; that can also be overseas investors, so that is a really important mechanism in this.

Q182 Nadhim Zahawi: Roger has told us about the percentage of his business that is UKbased, but Professor Kay reports that owners of more than 40% of UK shares are based outside of the UK now. What proportion of your clients is based in the UK?

Anne Richards: Just over a quarter of our clients are UK-based clients. I think the number is about 27%, give or take. The rest will be overseas.

Dominic Rossi: I think we would be slightly less in terms of our UK client base, given the fact that we have large businesses in Asia and particularly in Japan.

Harlan Zimmerman: In our case, almost none. So that we can make longterm investments, we require a threeyear lock-up from our investors. Most institutional investors in the UK are not comfortable with that, investing in listed equities.

Q183 Nadhim Zahawi: What proportion of your funds is made up of UK companies, and what proportion is foreign companies?

Anne Richards: For us, a little less than 10% of our total assets under management will be invested in the UK stock market.

Dominic Rossi: Coincidentally, ours is about the same level.

Harlan Zimmerman: We have 12 investments in total; four of them are UK companies in which we own between roughly 7% and 20%. These are FTSE 100 and 250 companies.

Q184 Nadhim Zahawi: I do not know whether you can help me with this question, but in terms of voting, do you tend to take more or less interest in your UK companies versus your foreign-owned companies? Dominic, I think you addressed that by saying it is a cultural thing inside the business.

Anne Richards: For us it is right across the board. We have the same level, the same aim to attend AGMs where we think it is particularly important to do it. We aim to vote all of our shares unless there is a share-blocking mechanism. So it is absolutely the same. We have a unified process.

Dominic Rossi: The issues you face are very, very different. In the UK, much of our engagement with companies revolves around nonexecutive appointments to boards and management incentives. In Indonesia, you do not get asked about management

incentives, curiously; it is more about just trying to assert your rights as minorities. So you have to alter the agenda depending upon the environment you are working in, obviously.

Q185 Nadhim Zahawi: How are the roles of the fund management and corporate governance management administered within your institutions? How is it split?

Dominic Rossi: We have a separate corporate governance team, although I should add that they work very closely with the fund managers. We have a separate corporate governance team for two reasons. First of all, particularly in the area of management incentive and remuneration, it is quite a complex issue and we think it requires a specialist expertise. Secondly—and this is particularly important—it is around pricesensitive information. By having a corporate governance team we can be brought over the wall by a company much, much earlier on than we otherwise would be if that information went directly to our fund managers. Therefore, we can split the two off when we need to create a Chinese wall. It enables our fund managers to continue managing their portfolios, yet we can get involved in the appointment of an executive chairman or non-executive chairman and so on. So the separation fulfils two particular issues.

Anne Richards: We have the completely contrasting approach, which, as I have already mentioned, is very much to embed corporate governance within the fund management team. Perhaps for us that is more manageable given that we have the single unified investment process, our active holdings in the UK are a relatively short list and we expect our fund managers to be able to drill down deeply into it, and because we do not trade them very frequently. It is a different model.

Roger Gray: We have separate responsible investment and fund management teams—separate by five yards. The expectation is that fund managers who are taking the final decision to invest in a company will have incorporated the environmental, social and governance considerations into their decisions.

Harlan Zimmerman: Our strategy is specifically to invest in companies and try to make them better listed companies. Therefore, all of us are focused on the governance as well as the investment. The route to making them better normally is, in part, improving the governance, because that filters down into the areas of operational underperformance, bad strategic decisions, bad capital allocation decisions and so on. So, for us, it must be integrated.

Q186 Nadhim Zahawi: We have integrated, five yards and total separation. My supplementary to you is: what happens when a corporate governance manager votes in a way that will be detrimental to the shortterm share price? Where is the separation? Where is the wall? Take, for example, voting down the remuneration of the chief executive.

Dominic Rossi: We have a set of remuneration policies. The voting team will vote in accordance with those policies. To be honest, that covers 90-odd per cent. of situations, but you are right. There are

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instances where it is not possible. A classic will be where we have a takeover situation and we own both sets of shares. How do you marry that problem up? Those issues will often come to me to resolve one way or another.

Nadhim Zahawi: Presumably, if it is totally integrated—

Anne Richards: You would not get a situation where there was a disagreement, because we would come to—

Nadhim Zahawi: You would sell the shares, presumably, if you are voting down something that you do not like.

Anne Richards: We will tolerate short-term underperformance if we think that the longer-term goal is worth that price. If we think it is something where we have engaged with the company, they still do something that we dislike and we have to mark their card on this year, but we feel that the direction of travel notwithstanding that blip is right, then we probably would not sell the shares. There might be other instances in which we would. We are trying to focus on building the long-term value chain.

Q187 Nadhim Zahawi: Just in terms of human nature being what it is, you have a human being, the corporate governance manager. He does not like a particular decision and wants to vote it down. It is very hard when he is integrated inside the fund management side. How does that work, at a personal level?

Anne Richards: It is not a separate individual. The team have collectively decided that this is a share that they want to have in the portfolio. Then there is a controversial issue around a particular event that is coming up. They will sit down and thrash it out around the table and then will decide, taking everything into consideration, what the right way to go on that issue is. They will decide it collectively as a team, so it is not two discrete, separate buckets. It is very much collectively round the table. That is how we operate all around the world.

Harlan Zimmerman: It might be interesting also to ask some of the panellists about their observations of other players in the market, because I believe there are very few institutions in the UK where the corporate governance manager will be able to overrule a fund manager on something. There are exceptions, of course.

Q188 Nadhim Zahawi: That is what I was heading towards: you may be forced to do something that you do not want to do if you are a corporate governance person.

Dominic Rossi: If you accept that asset managers have a dual mission, which is my starting point, we have to recognise that there are moments when those two goals are diametrically opposed to one another. When we get to those situations in our organisations, that is when my office steps in.

Q189 Nadhim Zahawi: So there is a sort of umpire above the decision. Do you do the same thing, Roger?
Roger Gray: I have never seen one of these animals, which is half in favour and half agin, but if one

walked into our office, yes, I would presumably have to resolve it. I think a lot is down to the culture of the institution. Our fund managers and our governance people do not speak a different language, hence we have not had that problem in practice.

Chair: Could we call it an asset managers code adjudicator?

Anne Richards: If it is a really controversial one, it will come up to me before we put it in the vote, just for a common-sense check. That is unquestionably the case.

The other situation that Dominic described was owning both sides of the shares in a transaction, where there is a clear conflict or the possibility of a conflict on that. We have a dedicated conflicts of interest committee who will meet and thrash around all sides to make sure that there is an objective view brought to bear on the situation. That is part of the broader managing of conflicts of interest that can arise unwittingly from time to time.

Q190 Rebecca Harris: How often do you exercise your voting rights? How often do you vote on company matters? What proportion of your rights do you use?

Anne Richards: We aim to vote all our holdings.

Dominic Rossi: The same.

Harlan Zimmerman: Always.

Q191 Rebecca Harris: My next question is void, in that case. When would you decide to consult your shareholders before exercising your vote?

Harlan Zimmerman: Clients, perhaps.

Dominic Rossi: Typically, we do not, because we have a very clear set of policies around what we are voting for and what we would vote against, and that policy is available to clients. To be honest with you, if you are voting thousands of times a year, it is not practical to approach shareholders on every single vote. But you will have institutional clients, particularly in the defined-benefit area, where the client will retain the voting rights and it is up to them.

Anne Richards: I would say that it is broadly the same. When we are awarded a mandate, part of that investment management agreement will typically cover the situations and the way in which we would expect to exercise the votes on behalf of the client, if it has been delegated to us, or will exclude it if it has not. We have a defined set of principles that clients receive ahead of time on which we will typically do our voting. So we would not normally consult clients before voting on their behalf, because it is a delegated function.

Harlan Zimmerman: For us, although we vote, it is very unimportant to what we do, because you do not use votes to make a company better. Voting is essentially, as it is being used in the UK, either a mechanism to stop bad things from happening—when the defence mechanism works and the governance people at USS and Fidelity, who are also good, by the way, get together and circle the wagons, so to speak, and vote something down—or the threat of that. That is a bad compensation plan, a bad takeover, something of that nature. But that is not activity that is really making the companies better. That is a form of

engagement that is very measurable, but it is not necessarily very meaningful if the objective is to steward the companies and improve them, as opposed to stopping them from doing bad things.

Q192 Rebecca Harris: Lord Myners talked to us about the concept of tracking error and how it might distort the behaviour of fund managers. I wonder if you can explain how this works and also what one would change in the practice to have a positive effect on behaviour.

Dominic Rossi: Tracking error is a statistically based measure of the likely deviation of returns of the portfolio versus the specified benchmark. It has some success, in my judgment, over time, in predicting what that potential deviation of return might be. But I do not think there is anybody in our industry, who has managed money for a long period of time—certainly no senior PM or CIO—who would rely exclusively on a tracking error measure of risk to predict in any way what his potential deviations of returns may be. The industry is full of such measures and tracking error is but one. The only thing I would say about tracking error and why it has a greater relevance than maybe others, which is possibly why Lord Myners referred to it, is that when clients approach us about specific mandates, they invariably are advised by their consultants to feel obliged to set a tracking error target for that mandate. Is it particularly reliable? It has some success, but I would not say it has much more than that.

Anne Richards: As a measure of risk it tends to focus on short-term volatility of prices as opposed to the real long-term risk, which is that you get back less than you paid for an investment. It is the risk of capital loss that is the long-run risk you should focus on. A lot of short-term volatility in markets is driven by potentially extraneous short-term factors. For example, the Italian election result causes a fluctuation in the prices of UK equity stocks, the majority of which are not going to be affected one way or another by what has just happened in Italy, but it is affecting the prices in the short term. It affects their volatility, which then is captured in this tracking error number, because it looks at volatility. That sounds a bit technical, but one of the problems with tracking error is that it does focus on short-term volatility as opposed to thinking about the longer-term risks that you really run with an investment.

The other criticism that one might make of tracking error as a measure is that it presupposes that the starting point to determine the riskiness of your portfolio is the index, because it is a measure against an index. Our starting point when we build a portfolio is to think about the economic drivers of the businesses that we are investing in—what is going to drive Unilever's profits over the long term? What is going to drive Persimmon's profits over the long term?—and think about those cash flows. The fact that they may be 0.5%, 1%, 5% or whatever the number might be in an index is, to a degree, irrelevant in the starting point for building a portfolio. So there are different styles of how you manage money in the market and tracking error does presuppose that you

are benchmark-driven in how you build your portfolio.

Harlan Zimmerman: I will try to put a couple of things together. Roughly, a tracking error is the extent to which you can deviate from a benchmark, say a FTSE 100. We are not index-oriented, but for a client of Fidelity, who comes and says, "Our consultant has said you should have a tracking error of no more than this", that would basically imply that they really must be invested in 90 out of 100 FTSE 100 companies. I do not know what the number is. What would the number be?

Dominic Rossi: It could be very different, but the point is still valid.

Harlan Zimmerman: The point is valid in that it means that they are forced to hold a widely diversified portfolio. If you look at, say, the largest company in the FTSE 100, which is HSBC at about 8%, or you take the top 10, because of this tracking error institutional investors will be forced to hold virtually all of them. HSBC they may think is a horrible bank and a bad investment for all the reasons that Anne was mentioning, but to have a zero weight in something that is 8% of your benchmark is virtually impossible. So you have to hold it at 2% or 3% or 4%, even though, by definition, you are saying you think it is a bad investment.

This is a root of many evils. It forces the portfolios to be much, much greater than they need to be. Simon Wong was talking about this in the earlier panel. It means that five very good, hardworking governance people at USS have to cover hundreds of companies, and it is just not possible. Many problems of the investment industry are encapsulated by the very phrase "tracking error"—it is the word "error." If you are not in line with the benchmark, that is an "error". That is a root of many problems, as I say, because it causes over-diversification of portfolios and an inability to pay for resources necessary to work with them in a good way. It comes from going up to the top, which Roger could tell us about, sitting on the top of a pension fund. This is how the assets are allocated from the top: a certain percentage in UK equities where you have an expected return of X advised by the consultants and, as a proxy for that, you use the FTSE 100 or the FTSE All-Share. Then, to measure how closely you comply with that, you use tracking error. Those bands are then set and instructions are given to Dominic and Anne and they do the best they can within those constraints.

Roger Gray: We are all fund managers, and talking about risk measures is something we could do for the rest of the day. The Kay report talked against tracking error and in favour of an absolute risk measure. The piece that probably all of us would agree on is that no single measure serves all purposes. I will not give a big defence of tracking error, but it has its place in the pantheon of things that you use to understand your portfolio. There are different ways to do this, but it also has its place in how you choose to say, "This is what we want you to do; this is your mission" and that mission could be a wide-ranging, absolute risk-oriented, concentrated equity portfolio with a lot of activism, or it might not be. Typically, a passive investment is going to own the index and tracking

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error is going to be kept very tight. I am not saying that there is no purpose for a passive, but it will be within context.

This would be an area, by the way, in which it is dangerous for this Committee or indeed any Government or regulator to step in and say “You cannot use tracking error.” It is like saying, “You cannot use part of basic statistics in your job”, which would be a nonsense, but has it been overused? Yes. My last comment on this is that it is much more important how a manager goes about selecting what they invest in than specifically how you define the length of the rope that they are allowed. I agree that “error” is unfortunate. You could call this “active risk”; that is a more statistically neutral way of defining it. I see tracking error or active risk as something that says, “How much rope are you playing with?”, but I should also, in empowering a manager to do that, know how they are going to go about selecting their investments and be supportive that that is something that is in the long-term interest of the fund.

Q193 Chair: Can I just intervene at this point? We are behind time. We have something like another 13 questions to ask. Please do not feel obliged to answer every question, but if there is one that you feel you can contribute to, feel free to write in with a written response to it. That might just cut down on the amount of time we take.

Q194 Mr Walker: Aberdeen’s marketing and website makes quite a virtue of the fact that you visit companies before investing in them. Given the global nature of your business—and you explained you are very global indeed—what is the resource that needs to go into that? How much of a commitment is that?

Anne Richards: It is a big commitment. We have three regional centres—the UK, the US and Singapore; we then have local offices that feed into those hubs and we have fund managers on the ground in all those places, so it is a big commitment.

Q195 Mr Walker: Is it typical among all investors that they are trying to do physical visits?

Anne Richards: It is variable. Active managers will not, as a general rule. Some feel they can do it by fly in, fly out. Some feel they do not need to visit companies. There are many different models.

Mr Walker: Are there comments from the other members of the panel on that?

Roger Gray: We have all our investment team located in London. Co-location has plenty of advantages as well. Lines of communication are short. It does mean that they are spending a bit more time in airports than they might otherwise do.

Dominic Rossi: In my area, there are 600 people globally. Most of them are investment professionals, analysts and fund managers all over China, Japan, Asia, Europe. It is very much a local branch structure when visiting companies.

Q196 Mr Walker: That does mean that you will get out visiting companies on the ground rather than just head office.

Dominic Rossi: Absolutely. Indeed, we have always placed an emphasis, as a company, on proprietary fundamental research, so our analysts are building their own financial models of the companies. But it is not simply the companies in which we invest; it is across the whole market. It is pretty much waterfront coverage.

Harlan Zimmerman: We are different, because we have only 10 to 12 investments at a time. We have 22 investment professionals, two professionals per investment, so we would normally meet the companies dozens of times, literally, before we invest; that is very different. But I would say the vast majority of these sorts of visits that most institutional investors would conduct, even the best of them like Fidelity and Aberdeen, will be focused on understanding the company. This is not necessarily a feedback session where they are trying to improve the company. They are trying to use the information to make good investment decisions.

Q197 Mr Walker: A quick question to Roger: in terms of balancing fund management and corporate governance, do you feel that the pension industry has a different approach to the investment management market or is it very much the same?

Roger Gray: If you look at the industry as a whole, it is a highly intermediated arrangement, so most funds rely on external managers for the vast bulk of what they do. Therefore, it is rather important that they select those managers well and incorporate what they are expecting in terms of corporate governance behaviours within those mandates.

Q198 Mr Walker: Can I just ask two quick questions? One is about activist investors. A lot of the evidence we have heard in our earlier sessions, from Kay as well as from Lord Myners, has been very much that we want to see more activist investors. You described yourself, Harlan, as an activist investor. Could you differentiate what you feel makes an activist investor?

Harlan Zimmerman: Yes. The primary distinction is investing with a plan to do something. Governance, as I mentioned before, is often at the root of that. It is investing in a company that you might think is good but could be doing better. It is a full integration of the governance and the investment, as opposed to making an investment in a company that you think is good and then, if something is not going according to plan, mobilising your limited resources to stop that from happening. That is the single biggest distinction.

Q199 Mr Walker: I also see what you do is based very much on a concentrated portfolio.

Harlan Zimmerman: Yes. You cannot do it when you have 100 companies in the portfolio. Arguably you should, but it is just not practical.

Q200 Mr Walker: Looking at the brief CVs that we have, I think you are the only person on the panel who has spent time in the hedge fund side of the investment industry. I do not know if anyone else on the panel has done. Some of the evidence that we have heard has been very critical of the role of hedge funds,

in particular in driving a transaction-based focus and using their power as activists to drive through deals to make short-term gains against the interests of long-term value. Do you recognise that criticism?

Harlan Zimmerman: Yes, I do, absolutely. I do not think it applies to us, it will not surprise you to hear, because we do not use leverage. We do not short; we do not hedge. All we do is buy the equities and, as I say, we have an average holding period of about four or five years. But definitely, when markets are buoyant there are certain types of hedge funds that can easily get capital, the main provider of which, by the way, is pension funds. They can easily get leverage. They are short-term focused, and they then hunt in packs and seek to put companies in play or extract jumbo dividends or things of that nature. It was a strategy that was thoroughly discredited after the financial downturn, but I fear there will be more of it over the coming years.

Q201 Caroline Dinéage: On the basis that your voice is okay, can I just ask you this? Professor Kay recommended that companies should consult their major long-term investors over major board appointments. I just wondered what voice they have in terms of appointments and how that is connected to the role of non-executive directors.

Harlan Zimmerman: I will definitely make it through this question if you can. I have pointed to the importance of non-executive directors, and I think Kay does an excellent job of focusing on the agency problems in different parts of the investment world, but this one has been overlooked, I believe. It is the single biggest problem, arguably, in that, as I mentioned before, the investors are given the vote on who should be not just the non-executives but all the directors, but particularly the non-executive directors, so that they can act as stewards for our companies. Fidelity, even with the best will in the world, cannot look after the day-to-day operations of thousands of companies, so we have nonexecutive directors who are there, who are supposed to be doing that job for us.

Now, the companies will say they do consult with their major shareholders on nonexecs, and the asset managers will say that they do consult as well, but the reality is that when that happens it is a very superficial consultation in most cases. It very often takes the form of a Sunday night call before an announcement on Monday. If you look at one single damning fact, director elections here in the UK for nonexecutives are a rubber-stamping exercise. Between the 2009 financial crisis and the 2012 shareholder spring, in the FTSE 100 there were 3,042 director proposals that came to a vote. 3,040 of them were elected. The average yes vote was 97.5%. The statistics are no different in the 2012 shareholder spring from what they were over that time period.

Now, some people will say “Yes, but there was behind-the-scenes activity” and, yes, that is true. There were also 10 directors who were proposed and then, for various reasons, stood down before the election. These are not our figures; these are figures from PIRC. The numbers are just as bad when you go to the FTSE 250. So what do you have here? You

have, to borrow from Lord Myners, a North Korean voting system where the effect in reality is that the chairmen of the companies, who head the nomination committees, are effectively choosing their own boards. They are choosing the people who will act as our stewards, who will sit in the boardrooms, who we are asking to challenge the management team for us, to challenge the chair when a decision is not good. We are creating a dynamic that is totally wrong.

Of course there are excellent NEDs, and there may be some chairmen who say, “I want a bunch of really tough people in my boardroom, who are really going to challenge me”. But human nature probably leads to them picking people who do not necessarily have that attitude. Secondly, the people going into the room know that they are beholden to the people who put them there, the very people who are asking to be challenged by them. So a very big question is why we are not doing a better job of involving ourselves in not just the rubber-stamping but the actual nomination of non-executive directors, which is being done very successfully in some other markets such as Sweden and Norway, where they managed to avoid many of the problems that we had with lack of challenge, for instance, during the financial crisis.

Dominic Rossi: Could I add a little colour on that? Some of those comments I completely agree with, but our experience is somewhat different at the same time. First of all, the call on the Sunday night about a major acquisition, etc, is absolutely true and there are good regulatory reasons for that. Also, the voting patterns are a matter of fact. However, our own experience is that we, particularly in the United Kingdom, are quite actively involved in the nomination of non-executives, whether it be the chairman, the SID or the non-executives. In many cases, not only are we asked our views on individuals and whether they are suitable to sit on a board before the nomination is made, but quite frequently we are asked whether or not there is anybody that we might wish to suggest. We are asked to put forward a name. So I do not think that the dialogue that currently exists between boards and major shareholders like our own is so sterile that we have no influence over nominations, because there are clear instances where we have been very influential in who is on the board and who is the non-executive chairman.

Q202 Caroline Dinéage: With that in mind then—this is for all the panel—are there any instances in the last 12 months when voting decisions went against the recommendations of company directors or chairmen?

Dominic Rossi: I have just gone through the voting report. We have voted against with 20% of our votes, usually on management incentives.

Anne Richards: I do not have the number to hand, but we certainly are on record as having—

Chair: Could I suggest that this might be a question that readily lends itself to a written response afterwards, so I think we can move on.

Q203 Caroline Dinéage: I just wonder if any of the panellists practise high-frequency trading in their institution.

Harlan Zimmerman: No.

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Dominic Rossi: No.

Roger Gray: Not in our institution. We have some hedge fund managers who engage in trading practices different from what we could possibly do and would possibly do and it tends to be not in individual shares, but in futures or currencies.

Q204 Caroline Dinenage: It has been reported recently that the German Government intends to introduce a clampdown on high-frequency trading because it creates excessive market turbulence. I just wondered whether you thought the UK should follow suit.

Anne Richards: We have talked a lot about agency problems in markets, in the generic long-term investment food chain and the implications of that. There is another subset of market behaviours that have become technologically possible in a way that they were not before and I do not necessarily think that the market processes around the control of that or the taxation rules have kept up with the changes that technology has allowed. It is certainly an area that would benefit from much closer examination into what the genuine impact is. That is not a small thing in terms of studying and enabling it to be done, but it should be done, because there are some unintended consequences of permitting it. There are potential benefits from increased liquidity, so it is not a one-way street, but in terms of looking at the balance of the pros and cons, it would merit much closer observation than has hitherto been the case.

Harlan Zimmerman: I do not see that it brings any benefit to society whatsoever, personally.

Q205 Caroline Dinenage: The next question has largely been answered, in that case. Do you make use of derivatives or short-selling in your institutions?

Harlan Zimmerman: We do not short-sell, and we normally do not make use of any derivatives other than for short periods of time when we can buy exposure to a company indirectly.

Dominic Rossi: Our philosophy is that we like to find companies, buy them and own them. Shorting as a concept does not fit particularly easily with that overriding view of why we exist, but in some strategies for protection we do use principally index-based futures. Our involvement in single-stock shorting is extremely limited.

Anne Richards: The vast majority of our business is what you would call plain vanilla, long-only investment. As Dominic has mentioned, we use derivatives to provide market protection in certain instances or to effect a market view through futures or forwards on occasions. And there are occasions on which rather than buying an equity share by buying the physical stock, we will choose to get access through buying or, indeed, in some cases, writing an option on a stock. It is a very small part of our business and we just use it as another tool to get the economic exposure that we want.

Roger Gray: We do not engage directly in short-selling individual shares, but we do use derivatives for either hedging purposes or efficient portfolio management, which is the most effective way

promptly to execute a particular exposure that we wish to achieve.

Q206 Caroline Dinenage: Professor Kay recommended that income from stock lending should be disclosed and rebated to investors. Could those who feel they would like to contribute explain their interpretation of that recommendation and how it would affect the market and address the public distrust of short-selling and stock lending, please?

Dominic Rossi: On the stock lending, first of all, it should be very, very clear that the income derived from stock lending belongs to the client. That should be absolutely clear. The only subtraction from that would be administrative fees related to the stock lending programme, but the income belongs to the client.

With respect to the practice of stock lending, again, my board is extraordinarily conservative about this. The idea that we would lend the stock that we obviously like, otherwise we would not own it, to someone who is then going to short it does not really make much sense. It is not in the interests of our clients to have to foster that short-selling, nor is it in the interests of the company in which we invest. We do a very limited amount related to dividends and I suspect even that practice will stop shortly.

Anne Richards: We do not do stock lending in the majority of our portfolios. We have a number of funds where the board of directors have taken the view that stock lending is a valuable additional income and they wish to exercise it. Aberdeen did a review of this area last year and from the start of this year we took the view that in the interest of full transparency we did not even want to keep an administrative fee for Aberdeen. So we now take no direct income from stock lending whatsoever for any of our portfolios, but again it is a relatively small number of our portfolios that were in any case using stock lending.

Roger Gray: We do engage in stock lending. There is an administrative fee taken by the custodian who provides the service. We recall our stock for voting, which rather materially reduces the amount of lending we undertake.

Harlan Zimmerman: We do not do it at all.

Q207 Caroline Dinenage: Finally, Professor Kay told us that he thought a financial transactions tax could be a positive way of discouraging short-termism. How could such a tax be implemented so that it had a positive rather than a negative impact?

Roger Gray: We have one already in the UK—stamp duty—and it is quite high, so I am not sure that it is germane to this particular discussion of the UK equity market.

Anne Richards: I would just add to that. It is true we do, but it is not equally applied to all instruments, therefore there are ways of getting economic exposure that could get around it. So again, on the point that I have made a couple of times, looking at the tax regime and making it more economically consistent across a range of instruments would perhaps get around some of these behaviours. But it is quite a difficult area to see how you would implement a financial transactions tax in a really beneficial way to the end customer.

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Dominic Rossi: The point is, if the purpose of a financial transactions tax is to prohibit superhectic trading on the London Stock Exchange, it is not going to work. If it is to raise revenue, I think it will work spectacularly well.

Harlan Zimmerman: I personally support looking more seriously at fiscal and other measures that compel people to be more longterm. That makes it more costly for them to be short-term, and I believe that is why it is in the report.

Q208 Chair: There is just one thing that arose from the response to that question. Roger, you said we have an FTT and it is stamp duty. Yet everybody else says a financial transaction tax cannot work. If we have one, and presumably it is working, why can't any other form of financial transaction tax work? Is there anybody who could respond to that?

Dominic Rossi: I was agreeing with Roger. The fact is, here we are with a Kay report troubled about shorttermism in the stock market, despite the fact that we have a transaction tax called stamp duty. If stamp duty or a financial transaction tax was a cure for

shorttermism, we would not need the Kay report, because we would have solved it through stamp duty.

Anne Richards: I know time is limited, but I would just add to that. It seems to me that if you want to stop high frequency trading, if you choose that as your route, the most obvious route to take is to prevent people buying and selling within a certain time period. A tax is an indirect way of trying to influence the behaviour. If it is the behaviour you want to stop, stop the behaviour.

Chair: So you are talking about the German approach.

Can I thank you? It has been a marathon. I do appreciate your contribution. As I said, there are some areas that perhaps we would have wanted to explore further but have not. If you could respond in writing to the one question that we did not take, I would be grateful. Similarly, if you want to submit any further evidence to us, feel free to do so. If necessary, we will write to you with any questions that we feel retrospectively we should have asked but have not, and we will be grateful for your reply. Thank you very much.

Tuesday 5 March 2013

Members present:

Mr Adrian Bailey (Chair)

Mr Brian Binley
Paul Blomfield
Katy Clark
Caroline Dinenage

Julie Elliott
Rebecca Harris
Nadhim Zahawi

Examination of Witnesses

Witnesses: **Anita Skipper**, Corporate Governance Adviser, Aviva Investors, **Steve Waygood**, Chief Responsible Investment Officer, Aviva Investors, **Neil Woodford**, Head of UK Equities, Invesco Perpetual, and **Chris Hitchen**, Member of Kay Advisory Board Team and Chief Executive, Railpen, gave evidence.

Q209 Chair: Good morning. Thank you for agreeing to help the Committee with its inquiry into the Kay Review. I will start by asking you to introduce yourselves for voice transcription purposes. Can we start with you, Anita?

Anita Skipper: I am Anita Skipper, and I am the Corporate Governance Adviser at Aviva Investors.

Steve Waygood: Good morning. I am Steve Waygood, the Chief Responsible Investment Officer at Aviva Investors.

Chris Hitchen: I am Chris Hitchen, and I am Chief Executive of the Railways Pension Trustee Company. I served on the Advisory Board for the Kay Review.

Neil Woodford: I am Neil Woodford. I am a fund manager at Invesco Perpetual. I have worked for the same company for 25 years, running the same funds for most of that period.

Q210 Chair: Before we start the actual questions, I should say that we have a lot of questions and not much time to get through them. Some questions will be for the whole panel, but do not feel obliged to contribute if you feel that the previous speaker has covered any points that you wished to make. Obviously, if you have something to add to or subtract from what has previously been said, feel free to do so. Brevity is much appreciated.

I will start by going back to Lord Myners, and this is a question for the whole panel. When he did his report 10 years ago, he called the intermediary regime too complex, but so little has happened since then that Professor Kay stated that the “chain of intermediation should be shortened”. Why do you think the industry ignored Myners’s initial call for simplicity? What lessons do you think we should take from it? Who would wish to lead on that?

Anita Skipper: One of the reasons is that pension funds had a lot of other issues to deal with over that time—their own deficits and the governance of their own teams—and so the stewardship stuff came down the agenda. I think it stayed there because the economy and the issues for pension funds have been so great. Also, part of the reason is that pension fund trustees are not always experts on these issues, and the intermediary chain has increased because they need to get advice, they need to be confident that what they are doing is right and, if they are not, they need to employ people who can advise them.

Q211 Chair: You are saying that basically it just was not high enough on their list of priorities, and I think the issue of the lack of understanding of pension fund trustees is well understood. Is there any other member who would wish to add to or subtract from that? Chris Hitchen?

Chris Hitchen: I would substantially agree with what Anita said, but I would say that large pension funds have done a lot over the last 10 years to take control of their intermediary relationships, bearing in mind that they were only part of the whole picture. Certainly Kay in his report was very aware of the fact that it was not just about large pension funds or even pension funds in general; it was about all investing, and clearly there are many investors who are not represented at all. He was trying to find mechanisms that worked for the market as a whole.

Q212 Chair: That is an important point, because whilst it may be possible to argue that the pension fund managers had a specific set of problems that they may have prioritised, that is not really true of the industry as a whole, because they did not have quite the same set of problems. Did they just not take it seriously enough?

Chris Hitchen: Speaking for my own fund and for the pension fund industry generally, we took the Myners report extremely seriously. As I said, in many ways trustees have upped their game over the last 10 years. Anita is absolutely right: this has not been an easy decade for institutional investors generally, but for DB pension funds in particular we have had to contend with rising deficits, closing schemes, employers that can no longer afford to pay—all those kinds of things. These are big issues, and there have been secular shifts in the way institutional investing is organised in the UK. We are in a bit of an interregnum. I happen to run an open DB fund but there are not many of us left. There is going to be a new world of defined contribution schemes, which auto-enrolment is going to empower.

Chair: I agree with at least half of that statement; it has not been an easy decade for investors, but an awful lot of people have done very well out of it. I will perhaps try to focus.

Chris Hitchen: I would agree with that, too.

Q213 Chair: You have partly anticipated my next question, which was: has there been any strengthening

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or hardening of the regulation of the institutional investors? You have said the pension fund trustees have upped their game. What progress has been made, if any? I am quite happy to take a contribution from anybody, but, Chris, do you wish to elaborate on what you said previously?

Chris Hitchen: In the context of the interaction with UK companies, I would say that more investors are fully engaged than was the case 10 years ago and the extent of that engagement is much deeper. We have seen developments in stewardship codes, and we have seen more and more commercial asset managers getting involved, partly due to their clients asking them to do so.

Anita Skipper: I would not quite agree with that because, bar a few exceptions like Railpen, USS and a few of the large commercial ones, our experience is that many pension funds do not prioritise this at all. In fact, some today do not even know what the Stewardship Code is. There have been improvements with some of the larger funds, but a majority of them still do not even know what this whole issue is about.

Q214 Chair: It is a point made by FairPensions, PIRC and others: whilst some are aware and have signed up to the Stewardship Code, plenty have not, and for some of those that have, it is a pretty tick-box exercise. Steve, you wanted to come in?

Steve Waygood: Yes. Thank you, Chair. Your question was about the progress we have seen in the industry over the last, say, decade or so. If I think about the system, and I know that Professor Kay was looking for a systemic response to the problem of short-termism, there has been a lot more work in the area of stewardship or corporate governance by some of the sell-side brokers. There has been more work by consultants, and I would particularly point to Mercer and Towers Watson as doing reasonably good work in the area of analysing corporate governance and stewardship by buy-side fund managers.

Can I share some data that we have done at Aviva Investors? We have analysed three years' worth of the signals that we get from the market: the requests for proposals; the requests for information; and due diligence questionnaires. Some 89% of those requests for information ask questions relating to, "How do we behave as good stewards?" If I think back over the last 10 years, that is a significant transformation in the demand that at least some schemes are putting into their tendering process.

However, we cannot see how heavily that is weighed, and after take-on, with some notable exceptions, the vast majority of schemes do not raise questions regarding stewardship after we have become their fund manager. In other words, what I believe is that, whilst there is a significant number of questions now in these requests for information, it is almost a housekeeping exercise. It is not treated substantively importantly.

Q215 Chair: That is important. You said initially the requests that came from the market; are you talking about basically pension fund trustees? Who else might that include?

Steve Waygood: Our institutional clients, so, yes, you could consider them to be that, or foundations—institutional investors that come to us looking for a segregated mandate. We have analysed over 1,000 types of those different questionnaires that have come to us, so it is a meaningful piece of work. The average number of questions per questionnaire is six and a half, so broadly 10% of each questionnaire covers this area.

However, as I say, we cannot see how heavily it is weighted in the final decision, and our experience is that it is not heavily weighted in the final decision. But that is experience; it is not knowledge. Also, after we have been secured as the fund manager, there are literally only a handful of schemes that hold us to account for delivery of stewardship in a substantive way. In other words, demand is missing and, as an observation on the Kay Review, what he focuses on is supply—supply of more stewardship. I do not think there is very much in there that will lead to increased demand for stewardship and an informed oversight environment.

Q216 Chair: Could you very briefly outline how that demand could be increased?

Steve Waygood: With pleasure. The entire system has a role to play. Trustees should be very transparent with pension beneficiaries about what stewardship has taken place, and there could be a requirement for that to happen. Pension schemes should also be required to embrace the Stewardship Code, and comply or explain. Investment consultants have, I believe, an obligation, a duty of care, to scrutinise fund manager performance in this area and proactively raise it into the discussion with their clients.

At the moment, my understanding, based on some evidence, is that investment consultants—who are centrally important in the UK fund manager selection environment; I cannot overemphasise their importance—very seldom proactively raise this area in their advisory environment. They could and should be required to do that. Fund managers, for our part, should be more transparent with their voting record collectively as an industry, and there are other reports that we could be producing. I could carry on, but you asked me to be brief.

Q217 Chair: I think we got the gist. The next obvious question is: how could you enforce or change that environment without intrusive regulation? Do you think the investors' forum that is being proposed would have a role?

Chris Hitchen: I think it could. It is certainly something that we debated extensively in the Advisory Board. It is not as if it has not been tried before. I have even been involved in some previous attempts to provide an umbrella where investors can come together.

I think what Kay had in mind was something very specific: where there is an issue of the day with a particular company, there should be a safe place where all investors with a legitimate interest can gather together to discuss that and not worry about whether they are going to be seen as part of a concert party, or

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whatever it might be, because there is some implicit, if not explicit, Government backing for the endeavour. We recognised that it was very important that we did not just capture large pension funds or the big asset managers who operated for them. It was important to have everyone in the tent. Bear in mind that, of the £18 billion fund that I run, I should think less than 10% of it is invested in UK equities today. There are many international investors operating in a very significant way in the UK market. They all need to be brought into the same tent, and it was really an attempt to try to create that.

Q218 Chair: Can I move on? One of the things that emerged from our previous panels and questioning so far has been the nature of fund management and its disconnect from the companies whose shares they manage, largely because they have so many. When we questioned Myners, he questioned this idea that fund managers should talk about company strategy or be more closely involved with the individual company strategy. His line was: “Most fund managers have not done anything other than work in the City. They have never run a business,” and I presume that he is assuming that they do not really understand business anyway. What is your view on that? Anita, you are smiling. Do you want to lead on that then?

Anita Skipper: I was just looking at the fund manager. In our little group of fund managers, we actually do have fund managers who have run businesses themselves. The role of the institutional investor is to challenge the strategy that companies have put forward. Then we can decide for ourselves whether or not we believe it, and whether or not we will put money towards it.

Q219 Chair: Isn't that more easily done if the fund manager has been in a business and basically knows what it is all about?

Neil Woodford: Not at all. No, I do not believe so. I do not believe our role as fund managers is to tell companies how to run their businesses. We are there to hold their feet to the fire on things like capital allocation and strategy. In some respects, having run a business might be a disadvantage. That may sound a little odd, but the fact is that the interaction between a company and its shareholders should be based around holding management to account with respect to the shareholder agenda, and making sure that the board behaves appropriately with respect to its shareholders and particularly with respect to capital allocation. Essentially, fund managers are capital allocators; that is what our expertise should be focused on. That is where I think there is a deficit of understanding on boards. Capital allocation tends to be the issue on which we engage most actively with companies.

We are not experts in how to extract more working capital or where to cut costs or where to invest in terms of the micro-management of the business, and I think that would be counter-productive. Boards would become dysfunctional if all their fund managers were trying to chip in and tell them how to run their business. We are not trying to do that; we are taking a step back from that and operating at a higher level.

Chair: Brian Binley wanted to come in with a supplementary; he, of course, has run a business.

Q220 Mr Binley: And I have founded two. I might be very annoyed if fund managers tried to tell me how to run my business when some of the records suggest they cannot run their own business. That would concern me. Isn't there a very fine line between the sort of scenario you paint, and going slightly further and being involved in the prime decision-making of a given company with regard to the important issues that you are not equipped to be involved in? Isn't there a fine line and isn't there a tendency on occasions to go over that line?

Neil Woodford: It depends whether you behave like an owner or a trader, frankly. As a fund manager, my average holding period has recently been as high as 16 years. At the moment it is a bit below that but it is certainly above 12 to 13. You can imagine that, when you have that sort of relationship with a business and you are typically holding a business for that period of time, you probably see three chief executives come and go during that average holding period and you see the board turn over many times. So you are the longevity in that sort of relationship, not the board or the executive.

You can imagine in that sort of relationship, where you are a long-term shareholder, you are engaging with a company principally on strategy and capital allocation. In those sorts of situations, we think it is our responsibility to engage with that company, and to give our advice and ha'penny worth on how they should allocate capital.

Q221 Mr Binley: You did not quite answer my question, so I will press you a little further. The truth of the matter is doesn't Kay—and, by implication, Lord Myners—think that big pension fund holders are too involved in the direction of business? Isn't that the question he is really asking?

Neil Woodford: No, I do not think so. I do not read it like that.

Q222 Mr Binley: Having talked to him, I do think so. Let us accept that as a starting base. If that is the case, isn't that a dangerous situation, where the imbalance between the big fund holders and other shareholders is out of balance?

Neil Woodford: I can envisage a situation where, if fund managers or asset managers were disproportionately empowered to intervene or felt that their responsibility was to intervene in the day-to-day management of the business, that would create an imbalance in the relationship between the owner and manager, and would create confusion. The problem that I see today is the complete opposite, in that most fund management groups really do not behave like owners; they do not think like owners. If something goes wrong at a business, or if something happens in that business that they have not anticipated or the share price underperforms for a quarter, as Kay emphasises, they emphasise sale over voice. You have got to have a long-term perspective to emphasise voice over sale.

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My view is that the problem is the complete reverse: there is not enough engagement. Institutional shareholders do not take enough of an interest in the strategic direction of a business. There might be quite a lot of engagement over executive remuneration or non-executive director RemCos, etc., but to my mind the lack of involvement principally focuses on that sort of engagement around strategy and capital allocation.

Q223 Chair: I just want to come to a couple of quick questions. We have been on this theme for some time. This is to you, Neil, because in your *Policy on Corporate Governance and Stewardship*, you state that you will only “vote on shares listed outside of the UK, Europe and the US by exception”. Why is that?

Neil Woodford: I do not know, to be honest. I am a UK fund manager, although I hold shares in companies quoted in other markets in my funds. I run about £32 billion and about 20% of that is invested in businesses quoted on other markets. We do vote those shares. I am not responsible for the other fund managers in the other parts of the organisation. I read my Stewardship Code the other day and thought it was a worthy document, but the problem is not really in the documentation or in the policy; it is actually in the implementation.

Chris Hitchen: At the Railways Pension Fund, we do vote our shares around the world, and we have a small team that works really hard to make that happen. We also partner with other institutional investors around the world. It is not a costless exercise by any means. It is really quite difficult to do it properly, and especially if you are going to engage with the companies as well, there does need to be enough resource put behind it.

Anita Skipper: Yes, that is important.

Q224 Chair: To a layperson it would seem that, if a fund had a strategy for investment, it would exercise that strategy consistently with both UK and other companies. It seems a little odd. My next question was going to be: is this typical of other companies? From what you said, Chris, it is not necessarily typical.

Chris Hitchen: It is typical of our fund and a number of other funds.

Q225 Chair: What is the view of the industry in general?

Steve Waygood: I can certainly agree with everything Chris has said—and, for that matter, Neil. We vote our shares on the MSCI World Index very actively. One reason why other fund managers do it less might be because of asset allocation decisions in our UK market. We tend to run a lot of UK equities, and as a consequence of that you will own more of a company in the UK than you would of a company in, say, Japan—or France for that matter. Therefore, if you own less of it, your return on your stewardship engagement will be lower and your ability to influence the company will be lower.

You should regard our industry also as one that is resource limited. We need to focus our resources on those areas where it is going to provide the greatest

return to our clients, and that often means companies where we have got the biggest investments in market cap terms.

Q226 Chair: Again you have partially anticipated my next question: how much of a burden would it be? I will bring you in in a second, Neil. In effect, the more companies that you invest in, the greater the potential burden if you wish to scrutinise them closely. Of course the more foreign companies, I would guess, the greater the running costs. From the nodding of your heads, is that a reasonable observation?

Chris Hitchen: Yes.

Neil Woodford: There can be a disproportionate focus on voting as representative of your corporate engagement. In the environment that I experience day to day in the UK, corporate engagement is a bit like an iceberg. The bit that you can see above the surface is your voting record, but the vast bulk of your engagement is actually below the surface. It is not obvious how you engage or when you are engaging. Typically, when we get to the point where we are abstaining or voting against various corporate executives, that tends to be the surfacing of legacy issues that we might have been debating with a company for maybe years. It would be wrong to correlate a voting record necessarily with your level of corporate engagement. Lots of people vote but do not say or do any corporate engagement.

Q227 Chair: I would certainly accept that observation, but to turn it round the other way, it seems odd, if you were engaging, that you did not actually exercise your vote.

Neil Woodford: Indeed. I agree with that, yes.

Q228 Chair: So, on the surface, there is an awful lot of non-engagement in companies that substantial funds are invested in?

Chris Hitchen: Chairman, I think Professor Kay would agree with your premise that many fund managers are over-diversified, effectively, and it limits their effectiveness in engaging. I would say that Neil is an honourable exception in that. Kay’s proposal to deal with that was that fund managers should have much more conviction, hold smaller portfolios and be much more prepared to deviate from market benchmarks. That of course requires us as customers to set them benchmarks that are more appropriate for a long-term approach. I think he envisaged a market place that was bifurcated between very active investors and effectively an indexed—tail to mop up the rest of the institutional assets. It is very important that we have proper stewardship of those passive assets as well.

One technical issue is that, to the extent that even large funds like ours invest through pooled vehicles, whether passive or not, it is sometimes hard to get the fund managers of those pooled vehicles to give you your share of the ownership rights and to vote in the way that you would wish. One thing that Government could think about would be more than polite encouragement of fund managers to do that.

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Q229 Rebecca Harris: We spoke last week to four representatives of the fund management industry who all seemed to have quite commendably high levels of exercising their voting rights, but not one of them actually consulted their clients on how they wanted them to vote. How typical do you think that is of the industry generally?

Steve Waygood: When one tries to do that, clients often tell you—but by no means all of them—that they have got other priorities on their mind, and this area is extremely complicated. If, for example, we were to bring them our Stewardship Code or our corporate governance policy and explain in detail how we vote, that would take a good few hours of a trustee meeting, and it is generally, typically, not something they are willing to invest the time in. They will delegate it to us. They will expect us to report back to them on what we have done in our quarterly reporting. Again, I mentioned earlier the lack of interest post take-on, post us running the funds, and with the honourable exceptions excluded, I can count on one hand the number of questions over the last 15 years I have had on the content of the stewardship section in the investor report that we give our clients. It is a problem of time being allocated by clients to this area, but by no means all of them.

Neil Woodford: In my organisation, and certainly within my area of responsibility, I have hundreds of thousands of clients—individual savers through ISAs and investment products—and it is not possible to engage with them to evaluate what they would like me to do specifically on each individual issue. I make a point of expressing to their representatives, the IFAs and the interactions I have with their representatives, how important I think corporate engagement is, and I think my track record speaks for itself on that front.

Unfortunately, it is impossible for us, or me specifically, to get a clear view of exactly what they want me to do on each specific issue and in generality even. I think the overwhelming desire is for fund managers to take ownership responsibilities seriously. That must be a given, and I assume it to be a given, amongst my investor base, and I take that seriously.

Chris Hitchen: I think the challenge for Government might be how to construct stronger governance models to represent investors. We keep going back to pension funds and particularly large pension funds, where the trustee model arguably does provide some level of oversight and governance, and you are saying it is weaker further down the chain.

We have a lot of subscale pension funds in the UK, but we also have hundreds of thousands of other unrepresented retail investors, as you say. I am involved with an initiative called Pensions Quality Mark, which is trying to build good governance into the new defined contribution schemes that are coming up, but arguably we need something even broader that would cover Neil's clients as well.

Anita Skipper: Something that one of our fund managers suggested was that, if you have retail clients, you should have a “meet the fund manager” once a year. So if you are running unit trusts where you have lots and lots of investors, you could have a day like an AGM that companies have but you would actually have the fund manager there, who will answer

questions from any interested individual who might want to turn up and find out how you are running the fund for them.

Chair: That is a very interesting suggestion.

Q230 Nadhim Zahawi: Just picking up on Neil Woodford's point, explain to me why it is impossible for you to engage with them.

Neil Woodford: Kay talks about disintermediation and the complex chain that exists between saver and company. The fact is that our relationship with our clients is dis-intermediated by umpteen different representatives. It is just not possible for us to access them.

Q231 Nadhim Zahawi: Why is that? There are technologies available now that mean you can talk to all the different stakeholders.

Neil Woodford: We often do not know who our clients are.

Q232 Nadhim Zahawi: Shouldn't you find out?

Neil Woodford: We cannot find out; we are not allowed to find out. We do not own the customer relationship, for example. It is owned by intermediaries.

Q233 Nadhim Zahawi: So you could consult with the intermediary.

Neil Woodford: Yes, we can, but again, coming back to the point that has been made here, many of those intermediaries are not interested in asking you about corporate engagement.

Q234 Nadhim Zahawi: It depends how you ask them, right? There are technologies available now for you to engage. This place engages with hundreds of thousands or millions of people. Other countries do the same thing in lots of different areas of business. It is available. I put it to you that there is a sort of reticence from your side of the fence to say, “Actually, that is the way we have always done it; we are going to carry on doing it that way because my reputation speaks for itself,” which is fantastic, but you should not close your mind to what is available nowadays. There is technology that has moved on.

Neil Woodford: I am very aware of what technology exists.

Nadhim Zahawi: So why not use it?

Neil Woodford: I am not suggesting that my industry is doing a good job. By the way, I am not defending it.

Nadhim Zahawi: It sounds like it.

Neil Woodford: I am saying that I am an exception in the industry. I take corporate engagement very seriously and I spend a lot of time on it. I can submit umpteen amounts of evidence to demonstrate that.

What I am saying to you is that typically I am on my own when I am engaging or among a very small number of people who are engaging with companies. The industry, I believe, is failing on this point. I am trying to offer some explanation as to why. But it is possible, even when you do not have that direct relationship with your clients, to accept the responsibility of ownership, as I do.

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Q235 Nadhim Zahawi: The issue I am taking up with you is you opened with a statement saying, “It is not possible for me to engage.” I do not believe that is true in today’s world. Thank you, Chairman.

Chair: I think Steve Waygood wanted to come in on this.

Steve Waygood: Thank you, Chairman. Many companies routinely now engage with stakeholders, and that kind of engagement is, of course, something that we support and encourage them to do. We, as Aviva, have 14 million retail customers in the UK. Whenever we have raised questions like this, many of them, once it is explained to them what it is we are doing, are genuinely interested in understanding more. However, I mentioned at the very beginning of this meeting that the active informed demand for good stewardship is missing. To me, this is a function of poor financial literacy in the UK. There is an opportunity in the revision that is currently under way of the syllabus to integrate issues of stewardship within that. Of course, that is a long-term way of dealing with a short-term problem. It will take many years before those people are demanding good practice from us.

The central problem is demand—informed demand. They would also need quick and efficient ways of overseeing something that is very complicated, so any work that is being done to develop a standard is something that we would very strongly welcome.

Q236 Rebecca Harris: What opportunity is there now for clients to make their views known to you? What opportunity is there for clients to influence your voting decisions at the moment? This is particularly to Neil.

Neil Woodford: In my particular example, when I interact with clients, or when people who work with me interact with our clients, there is an opportunity then for them to express their wish and their desire for us to engage with the companies in which we are investing. I absolutely agree with the point that has been made on this panel, which is that there is very little attention paid to this. Sometimes we are offering up the whole subject of corporate engagement and activism with our clients, rather than the reverse.

Chris Hitchen: It depends on who you mean by client, though, doesn’t it? If we are looking through to the end investor, then I accept it is not impossible but I would agree with Neil it is difficult. One of the Kay recommendations was that Government should facilitate individual electronic registration, which has really not happened in this country. That would make it much easier to democratise shareholders.

Where the client, as far as the fund manager is concerned, is a governing body such as a trustee, the mechanism is there for that relationship to happen—for the client to instruct the fund manager. We certainly do that. But I would say that fiduciary duty is a concept that occurs a few times in Kay’s report, and it really goes to the core of my job. It is not the same thing as doing what your members want you to do; it is doing what is in their best interests, and those two things are not always the same.

Nadhim Zahawi: But you can explain that.

Chris Hitchen: Indeed.

Q237 Rebecca Harris: This is a question for Anta Skipper and Steve Waygood. Aviva was recently forced into this “shareholder spring” spotlight last year, when about six out of 10 votes failed to support the pay policies the company put forward. Firstly, what proportion of Aviva shares are held by institutional investors?

Steve Waygood: I should emphasise we work for Aviva Investors rather than Aviva, so we will need to come back to you to give you an absolute fact. I would estimate the majority, if that gives you a ballpark for your subsequent question.

Q238 Rebecca Harris: My next question is: what effect do you think this shareholder activism had on short-term performance or the long-term outlook? What would you say was the impact of that?

Anita Skipper: It was a case where activism from disgruntled shareholders had an effect, because there is now a new chairman, a new CEO and a review of the business. This is activism in practice.

Q239 Rebecca Harris: So it benefits long-term performance?

Anita Skipper: That is why shareholders would do it.

Rebecca Harris: So it has an impact?

Anita Skipper: Yes.

Chris Hitchen: The important thing is to create a climate where companies are well governed, and so our interventions are not so much a kneejerk to say, “We do not like you or this particular thing.” It is more to create a climate where people are encouraged to do the right thing. In our own case, we are routinely voting against around 40% of remuneration policies, but it was pretty much the same before the shareholder spring.

Anita Skipper: It was.

Steve Waygood: In terms of our own voting levels, they are similar. One of the things I would also highlight, given that you have raised incentives, is I very strongly welcome Kay’s own focus on incentives within the system. The debate around the Shareholder Spring has, particularly last year, focused, possibly unhelpfully, on just board pay.

We have heard about a tip of the iceberg already, but pay is the tip of a different iceberg. The supply chain of capital has many intermediaries within it, so I think it is a very healthy conversation to be having around how one restructures broker incentives and how one restructures fund manager pay. How are the incentives around investment consultants restructured so that the short-termism that you are analysing is reconsidered throughout the entire incentives of the supply chain?

Chair: We will be coming on to these issues.

Steve Waygood: This morning? I do have a specific point I wanted to highlight, so do you mean we will be coming back to them this morning in this questioning?

Chair: Make it now, if you wish to.

Steve Waygood: Thank you very much, Chair; I appreciate that. We have been working with Tomorrow’s Company to produce something called Tomorrow’s Capital Markets.

Q240 Mr Binley: You are not selling to us, are you?

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Steve Waygood: It is free. We have sponsored this study and made it freely available. We are inviting other fund managers, other consultants and other brokers to work with us and Tomorrow's Company to open up how their incentives are structured and then try to establish how to include questions of stewardship and good ownership within that area.

If I can make a general point, our industry spends a huge amount of time and money trying to analyse how well fund managers enhance returns—how we are adding alpha to our clients. There is very little time or money spent on the question of how we are doing good stewardship. Yet I believe that is an industry that can be measured. There surely should be ways of measuring the substantive performance around engagement and voting and interactions and how we have held managers to account for their own governance of the firm. There are not those measures and metrics.

There are a few areas, perhaps, where they are evolving. One area is the UN-backed Principles For Responsible Investment, which now has over \$30 trillion worth of backing. They have an annual assessment of their members' performance in this area, and there are elements of that assessment that could be harnessed to actually measure the performance in stewardship terms.

As a final point, Kay's review does not look at that. It does not look at how you measure stewardship. If we were to look at that, you would manage what you measure, and you would start to see a transformation there.

Q241 Paul Blomfield: Neil, you were talking a moment ago about the barriers, limitations and difficulties with engagement, but your website says that shareholder activism is fundamental to good corporate governance. How do you define shareholder activism and what do you think needs to change to improve it?

Neil Woodford: In brief, I would say that, if you think like an owner, you will be by definition actively involved in stewardship and governance of the company. If you believe that at the first disappointing piece of news or the first opportunity you can exit the shares and move on to something else, then you will never think like an owner, and therefore you will not be actively engaged with that business. Ownership is crucial—a sense of ownership on behalf of obviously the asset owners as well as the asset manager. You can behave like an owner by proxy.

Q242 Paul Blomfield: How do we get to the point where people are thinking like that? What needs to be done?

Neil Woodford: We talked about incentive structures, and what we need to do as an industry is to think more long term about our investments, and the failure in the industry that Kay points out so well is a product of excessive short-termism. The short-termism exists at almost every link in the chain that exists between saver and company. We need to tackle that short-termist culture in each segment of the chain. Asset managers need to recognise their ownership responsibilities more readily. The intermediaries who

represent the savers, the clients, need to think about the incentive structures that they put in place, which create the wrong sort of behaviour in the asset management community. Regulation has a part to play as well—excessive regulation—and remuneration, of course, in the fund management industry. In the links in the chain, there are also issues that need to be addressed.

There is no one silver bullet; I agree with Kay that there is no one answer to this. Where we are today is the product of 20 or 30 years of market history and regulation, and it will take a long time to get to a better place. To my mind, there is no single thing that can deliver that outcome, but lots of little things can encourage the right sort of behaviour over time.

Anita Skipper: FairPensions' clarification of fiduciary duties could actually help here, so long as the result of the Law Commission's work goes in the right direction and says it is a duty for owners to think long term, but if it does not, then we start all over again. Basically the whole chain has to have the same sort of basis of duty, right through from the ultimate owner to the company.

If you start with a pension fund who has a duty to be long term, that will then filter through to the fund manager, who will then engage on a long-term basis, and then it will affect the company and allow it to have long-term shareholders. Until that alignment is there, you will have all the short-term investors coming in and becoming too much of the critical mass. We are not saying that everybody needs to be long term, but what we are saying is that we have not got a sufficient critical mass of long-term investors.

Q243 Paul Blomfield: Can I come to one of Kay's specific recommendations? As Neil says, there is no one silver bullet, but one of the specific recommendations is the investors' forum, which has been welcomed. However, when we met Lord Myners, he was supportive but sceptical that it would have an impact. Chris, today you have defined its role quite narrowly.

Chris Hitchen: I tried to explain the thinking that occurred.

Paul Blomfield: I wondered what you all felt about the investors' forum in terms of addressing some of these issues.

Chris Hitchen: I have explained the thinking that the Advisory Board had around it. It is easy to be sceptical about it. As I have said, initiatives have foundered before. I do think Lord Myners is someone who could make it happen, as it happens, but that is a matter for him. We did see it very much as providing a safe environment for investors to come together to engage on particular companies and issues.

Q244 Paul Blomfield: Is that how everybody else sees its role? Do Neil, Steve and Anita see the role in that way?

Neil Woodford: As a practitioner, I would say investors are not good at coming together and talking about investment issues. Corraling investors is a bit like herding cats. It is very difficult to get investors even to agree to meet on a particular subject, even if it is particular egregious.

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Chris Hitchen: They are scared to meet, because the FSA or Takeover Panel might be suspicious.

Neil Woodford: That is one of the principal reasons why investors are reluctant to communicate with each other. I have had umpteen examples of trying to pick up the phone to CIOs in rival fund management groups, who have expressed encouragement but little more than that and wished me luck in a particular endeavour. I believe a lot of other things need to happen alongside an investors' forum to get the best out of an investors' forum. On its own, I do not think it will achieve very much. If other things were put in place around it, I think an investors' forum could be really beneficial.

Q245 Paul Blomfield: Could I press Chris a little bit more on it? The way you describe it is almost as a tool for crisis intervention as opposed to something that could actually shift the culture and approach that Neil was talking about, and I just wondered how the rest of you felt about that.

Chris Hitchen: Sorry, are you pressing me or the others?

Paul Blomfield: I would welcome other people's views, but could you just come back?

Chris Hitchen: We are all in better shape as regards having generally improving standards—ratcheting up codes and those kinds of things. Business as usual day to day is less in need of a specific intervention. It is really how to deal with a particular takeover or whatever it might be, where we could probably get a better outcome if there was a safe place for people to talk about it.

Anita Skipper: Part of the reason why there is not much enthusiasm at the moment is that it has not been defined. People are not sure what this forum is supposed to be doing over and above what already happens. We think there is potential and the forum can add a lot of value.

Q246 Paul Blomfield: How do you want it defined to do that? Steve, you might be going to answer that.

Steve Waygood: Yes, absolutely. As has been alluded to by everybody, there have been a number of attempts to do this before. What is different this time? Why should the industry stand up and supply more stewardship simply because it has been suggested by a review? For me, one of the key questions is how much resource that forum, or those fora, will have. I do not think it necessarily needs to be just one forum. I can certainly envisage a very positive role for the forum that is being discussed by the IMA. I would encourage the market perhaps to supply more, and for there to be a competitive environment. There is nothing de facto about a forum that means that collaboration will be more effective or efficient and lead to better portfolio decisions.

Fora can be extremely bureaucratic and ossify our ability to engage; they do not always necessarily work well. The ones that work well are the ones that are well resourced, and we have a proposal for that. It actually touches on the submission that Lord Myners made to you too, where he was talking about how research commission could be allocated.

Very simply, I have two budgets that I can call upon. One is the budget that pays for the people in my team, so that comes from our P&L as a firm—from Aviva Investors' own bottom line. There is also research commission, and that commission is generated every time we make a trade on our clients' portfolios. It is our clients' money that generates that commission, and roughly about 0.15% of every transaction is a commission. Two-thirds of that, if it is a large UK company, is funding research in the sell-side, so brokers.

I believe if we were to create an enabling environment across the City that encouraged—not required, but encouraged—fund managers to allocate a proportion, let's say 10% to 20%, of their research commission towards stewardship, meaning brokers analysing the quality of governance, the quality of the sustainability strategy of the company and its business ethics, then I think you would see tens of millions of pounds more funding good stewardship work. I would envisage at least one of the investor fora, if not many, being fundable through that way. Why shouldn't independent research cover stewardship? Why shouldn't it cover corporate governance?

At the moment, the point to emphasise is that many of my peers within other fund management institutions do not use their research commission pot of money to invest in this way. We do; Aviva Investors does. But I know a lot of our compliance colleagues in other firms are hesitant. You will have seen the press today looking at corporate access as an issue, so understandably you have very hesitant compliance teams.

A transformative proposal is embedded in one of Lord Myners's suggestions, which is to enhance the use of research commission for stewardship. That has not been considered in the Kay Review: how would you finance the forum? How would you fund stewardship? I find that an odd anomaly, given that clearly we are talking about an area of economics.

Q247 Chair: This is a very significant suggestion that you are making. Chris, if I can put you on the spot, why did Kay not make any observations on that?

Chris Hitchen: On the way it should be funded? Professor Kay devoted basically a year of his life to the construction of this report, and I think most commentators would agree it is an extremely elegant and accurate picture of the world we find. As Neil said earlier, the solutions are not easy to find, and I would agree that if the pendulum spent 30 years swinging this way, it is going to take 30 years to swing it back the other way.

Q248 Chair: It seems odd to the layperson that an exercise that took so long should not actually make that many positive recommendations at the end of it, particularly when we have just had one here today that would seem to be, if you like, waiting there to be introduced.

Chris Hitchen: I did not write the report. I can speak for the discussions we had around the Advisory Board. Ultimately, if we had had another six months or a year, we might have gone further into the

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solutions, but I think Professor Kay felt that other people would come forward to do that.

Chair: I will bring you back in, Steve, then I will come back to Paul, because I am conscious that we are running behind time.

Steve Waygood: Just very briefly, this is an idea that has come to us through reading the Kay Review and participating in the conversations afterwards. We did not submit it whilst Kay was considering his evidence, so it has been inspired by these conversations.

Chair: We will see Kay as an inspiration. I believe Paul has to leave soon.

Q249 Paul Blomfield: Let me just pursue this a little bit more, moving away from the investors' forum and looking at the other options that Neil was talking about. Kay talks about the two choices facing investors as voice or exit. In what other ways can we do more? In what ways can Kay's principles be implemented to encourage more investors to choose to change weaker companies rather than simply sell on?

Steve Waygood: The demand for stewardship: the suggestions that we have made around how consultants could be encouraged to measure stewardship, and how consultants could then be encouraged to advise their clients. It is not just pension schemes; I should also highlight that insurance companies of course own a considerable amount of the UK stock market. It is a matter of introducing standards and measures of good stewardship through the supply chain and the oversight chain and enhancing the financial literacy of the end investor, so that their IFAs, the Individual Financial Advisers, are also encouraged to scrutinise retail fund managers as well.

There needs to be a series of interventions in the whole chain—the demand and the measurement of stewardship. That goes for brokers too. One could require of a broker in their detailed notes on companies to offer a view on the corporate governance. It is exceptional when they do, these days; they do not.

Neil Woodford: Incentive structures are really important around performance measurement and the hiring and firing of fund managers like us. If those incentive structures were shifted to a longer term perspective, that would be a very important step in encouraging longer term behaviour and more engagement, i.e. voice over sale.

Chris Hitchen: That is true both of the fund managers and of the company managers. Arguably, long-term share ownership is the best way to align the interests of the company management with those of the investors. Similarly for the institutional investors, or rather their agents, I would like to know that their long-term remuneration is going to be broadly aligned with the needs of my members. So that is a key point. It is about defining what success is as well. Success should not be about beating the market today and beating the market tomorrow. To an extent, that makes it incumbent on us as trustees and trustee representatives to find different ways of measuring success. It would probably have to be more around, "Have you contributed real value to my pension

schemes' assets over many years?" rather than, "Have you beaten the market last quarter?"

Chair: There is a danger that you start debating amongst yourselves, and I realise that when you have got like-minded people all interested in the same thing, that can happen.

Paul Blomfield: Neil was agreeing, were you not?

Neil Woodford: Yes, I was agreeing.

Chair: I am conscious of the fact that we are running way behind time, and we have got another panel, so can I bring in Caroline Dinéage now?

Q250 Caroline Dinéage: Steve, and Anita as well, you have mentioned stewardship quite a lot this morning, and it is something that we have heard a lot about. Do you think the code is fit for purpose and what changes would you make to it?

Steve Waygood: Yes, we do. I am disappointed with the number of pensions that have signed up to the Stewardship Code. One of the proposals that we made earlier was around how we could finance stewardship through research commission. Personally, if I was rewriting the Stewardship Code, I would add a provision in there encouraging those people who sign up to the Stewardship Code to examine how they use their research commission to promote and finance stewardship. I could carry on, but those would be the two biggest things for me.

Q251 Caroline Dinéage: What incentives are there for the industry to take these codes on voluntarily?

Steve Waygood: Comply or explain matters. We have seen it work well in the UK corporate governance listed environment for plcs. It only works really well if the people who are being explained to read it and then feed back to the people who wrote it what they think. That is the bit that is missing. In the UK corporate environment, there is an AGM and a series of votes at the AGM that enable the owner to then communicate formally back to the company. Of course there are in between times plenty of meetings too that enable that to happen. We have the meetings in the investment world—we meet our clients—but we do not have a formal opportunity for them to say what they think about our Stewardship Code. The oversight bit is missing with comply or explain.

Anita Skipper: It goes back again to the demand side of it, because if you are not complying with the code and you have not got your name on the FRC website and nobody cares anyway, then nobody is incentivised to do it. What you need is an environment where complying with the code is something that is seen as a good thing and that everybody is supposed to do, but we are not there yet.

Q252 Caroline Dinéage: How long do you think we should wait to see if firms volunteer to take on the code before we insist on legislating them to do so?

Anita Skipper: A lot of fund managers have already signed up. The disappointing bit is that the owners have not signed up. You want the owners to sign up so that the fund managers actually do the work for them. Fund managers do see the benefit of engagement, which is why Neil spends so much time engaging with companies, but it is very difficult to

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keep increasing that when nobody is asking you to do it and they do not even care. The focus must be on demand from our perspective.

Neil Woodford: On its own, I do not think it can achieve what it sets out to achieve. We talked today about lots of little steps to encourage different sorts of behaviours. On its own, the code is a splendid document. Our Stewardship Code is a splendid document. But even within my organisation, I doubt whether many of the fund managers who are engaging with companies have even read our Stewardship Code, let alone implemented what we say we do. So there is a certain amount of paying lip service to it. We have evidence there it is sort of a box-ticking mentality to a certain extent.

Again, coming back to what I said earlier, you have to think like an owner before you can take those Stewardship Code responsibilities seriously and implement them in how you run money for your clients.

Q253 Caroline Dinéage: Would you advocate some kind of compulsion, then?

Neil Woodford: I am instinctively concerned about too much regulation. Kay talked about this again in the review. Regulation is encouraging the wrong sort of behaviour, so more regulation may not be the best way to go, or if there is more of the right sort of regulation, there should be less of the wrong sort of regulation commensurate with that. I am nervous about too much regulation but, in and of itself alone, it will not deliver what we want it to deliver. Behaviour has to change over time with a whole structural change in terms of incentive structures in the industry.

Anita Skipper: What I think has made a big difference is just the publicity this has all got in the press every day. That has started the momentum towards much more awareness of stewardship and long-termism. It would be helpful to be able to keep that profile until we actually achieve whatever it is we are trying to achieve.

Q254 Caroline Dinéage: Can I move on to Chris, please? The pension industry will soon be seeing a massive expansion due to the auto-enrolment scheme. Do you feel that the industry is ready for this, and what changes are being made to prepare for the new clients and funds?

Chris Hitchen: I perhaps should declare I also happen to be a trustee of NEST, the new Government-sponsored pension scheme, which will be one of the vehicles used for auto-enrolment. We are seeing the potential emergence over the next decade of a relatively small number of large players in the defined contribution world. There is a reasonable chance, particularly with initiatives such as Pensions Quality Mark, which I already mentioned, that those will in the main be well governed, whether through trustee structures or other means. It could be a way of ensuring that UK institutions do have that scale, which in the main they so far lack. The long-term picture might—provided those institutions are allowed to get off the ground—be better in terms of ensuring that savers are appropriately represented.

Chair: Can you address your remarks to us rather than fellow panellists? Have you finished now, Caroline?

Q255 Caroline Dinéage: Just very briefly, do you think that governance and stewardship practices in the pension fund industry need to change to accompany the greater influence that pension funds will have in terms of their market share?

Chris Hitchen: As I said earlier, there is a dip at the moment; pension funds have been on the wane, and it is going to be a while before the new schemes really rise again. There are constantly advances in technology, and certainly at NEST we are thinking very hard about how we ensure that there is direct engagement and information available to scheme members, whilst still remembering, as I said earlier, that we have to do what is in their best interests, rather than what they might actually want us to do.

Q256 Katy Clark: Short-term shareholders can influence mergers and acquisitions, often forcing decisions on longer term shareholders that perhaps they do not want. Do you think that short-term shareholders should continue to have the same voting rights as those with perhaps a longer term interest in a company?

Anita Skipper: Yes. I think that the “one share, one vote” principle is the fairest principle. There are too many problems once you start giving out differential voting rights, and things that are not actually supportive of what we are trying to do here. You could entrench management whom you are trying to persuade to change what they are doing. Because of differential voting rights, they are entrenched. So there are lots of reasons. It is practically quite difficult as well, so we would prefer other means of actually making things more long term.

Q257 Mr Binley: Can I pursue that? Can I refer to Cadbury? That was a pretty glaring example of short-termism in takeover situations. I wonder whether we ought to be crude enough to say, “You have to own shares for three months before you can vote on the future of the company”? Is the only way to deal with it a very crude line?

Chair: The takeover code has basically kicked this into the long grass.

Mr Binley: Yes, and I would like you to think again about it.

Neil Woodford: The subtext here is that the market in corporate control should be controlled. I am instinctively reluctant to agree to that.

Q258 Mr Binley: We are just talking about those people who can vote in a takeover.

Neil Woodford: Cadbury was sold in the end because the long-term shareholders accepted.

Q259 Mr Binley: Cadbury was sold in the end because they were bullied to sell in the end; let us be perfectly true with it.

Neil Woodford: Cadbury’s shareholders decided that the price that was being offered was attractive enough for them to want to sell their shares to the bidder. It

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is a simple law of economics that dictated the outcome of that particular bid, as in most cases.

Q260 Mr Binley: You are perfectly happy with an American hedge firm being more involved in British industry than they perhaps should be.

Neil Woodford: That is not what I said. What I said was that the long-term shareholders who owned Cadbury decided that the price that was being offered was attractive enough for them to sell their shares, because there is always, of course, an opportunity cost associated with investment. You can take your capital from your particular investment and deploy it more productively elsewhere.

Q261 Mr Binley: I think that is a very kindly view of what happened there. Are you telling me that you do not think that there ought to be a time limit before you are able to vote on the future of the company? Shouldn't you have some involvement for some time before that happens?

Neil Woodford: I am not saying that necessarily. All I am saying is that it was the long-term shareholders of Cadbury who dictated the outcome of that company's fortunes. It was not the hedge funds. They sold in the market to them—to the arbitrageurs.

Q262 Mr Binley: They had no alternative, but never mind.

Neil Woodford: They had alternatives.

Q263 Chair: We could probably hold a separate enquiry into this, and in fact we already have done. The basic point, leaving aside the Cadbury issue, is whether there is an argument for restricting the ability of short-term investors to intervene in a takeover situation.

Chris Hitchen: Just very briefly, I think there is a case for looking at whether you should be able to borrow shares to vote, and that is something the Government may wish to think about, and there are different ways you could address that.

Chair: Can we move on? I have got Julie Elliott now. Some of these issues have been covered, so please pick out those that have not.

Q264 Julie Elliott: As a matter of procedure, what steps do you take to check the suitability of companies that you invest in? Specifically, what do you look for when checking the companies?

Neil Woodford: How long have you got?

Chair: Not very long.

Neil Woodford: When you are analysing companies ahead of making an investment decision, the process never ends. You never stop analysing them when you have invested. If anything, the intensity of your scrutiny increases. You look at a whole host of things. Ultimately, an investment decision is really about value discovery. Kay talks about this in the review.

My job is really as a value hunter. I am looking for undervalued situations in the market. The most attractive or the most undervalued situations are, by definition, the best investments. The whole process of investment analysis is really about identifying

undervaluation—the mis-pricing or the mis-valuation of assets.

Q265 Julie Elliott: Do you think you are quite successful at doing that? Do you think companies are good at doing that?

Neil Woodford: Companies?

Julie Elliott: Well, organisations.

Neil Woodford: I think the track record of fund managers speaks for itself, broadly, in that when you measure the average fund manager, he does not beat the index. In many respects the industry falls down, but of course by definition the average fund manager will not be able to beat the index; we are, after all, contributing to the index. There are examples of fund managers consistently beating average returns. You have got to measure those returns over a very long period of time. As I said right at the start of this process, I have been managing the same fund for 25 years, and if you want to look at the long-term track record of that, I encourage you to do so.

The fact is, it is possible to deliver superior long-term returns, but you have got to have the right approach and focus on value discovery rather than—as we have talked about all day—the obsession with price over value, for example, which is inappropriate. It is possible to beat the market; it is possible to justify your existence and undertake your socially useful functions as well in improving the performance of companies and benefitting the economy in the process. The industry unfortunately is not set up sufficiently well to deliver that outcome. That is why we are here today.

Q266 Julie Elliott: Would everybody agree with that?

Anita Skipper: Following on from what Neil said, once you have made that decision and you have bought into this company and it is a strategy that you like, the ongoing engagement is whether they are sticking to the strategy, whether the people who are actually running the company are competent to run it and whether they are going to stray from the strategy. Quite often we get involved with the fund managers because the company is doing something that we had not bought into and it is a surprise. That is why, once you have made a decision, as Neil says, it is an ongoing thing, and in fact your scrutiny gets even greater as time goes on, because it is even more important then. You have spent all this money, you have held it for many years in this company, and you want the returns at the end of the day.

Steve Waygood: The only thing I would add to what has been said before is that, going back to the first question at the beginning of this meeting, one of the transformations that we have seen in this industry over the last 10 years is that very large organisations like Bloomberg, MSCI and Thomson Reuters are now adding to the conventional financial metrics qualitative views on the governance of the firms and their sustainability: how they deal with their customers and how they deal with their employees. It is beginning to be possible to enhance the qualitative view of the company with these metrics from, for example, Bloomberg.

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In the last three years, we have been very actively adding various measures of the integrity of a firm to our security selection process, portfolio construction and portfolio risk management. I am not pretending for a second that we have finished or we have got it 100% perfect, but what it adds to the view is interesting. It really does deepen it. It is an odd observation that Aviva Investors is one of the very few firms to have done that systematically. What is good is that the likes of Bloomberg now cover this.

Q267 Julie Elliott: Would you say that this extra information has made a difference in terms of the companies you invest in?

Steve Waygood: Yes, it does. Often it reinforces what was the fund manager's view already, and you would expect them to align, if you like. But where there is an anomaly—a company that has good financial prospects comes through MSCI's intangible value analysis tool with a ranking of triple C, which is very bad—that gives us an opportunity to then have a conversation with the fund manager about why it is ranked like that. It could be that we might sell down the holding, so the exit, or we could engage: the voice that Albert Hirschman talks about and that Kay uses as a key reference. There is a lot more to do. If you wanted to come and pay us a visit, we would be very happy to take you through the process.

Chris Hitchen: It is fair to say that we are talking about one particular kind of fund management, and there are many other kinds of fund management.

Chair: We need to move on.

Chris Hitchen: One very quick point: there are many reputable companies that use quantitative techniques, but many shares are actually traded by computers doing high-frequency trading and that is a million miles away from what we are talking about today.

Chair: We have covered that with other panels, and to a certain extent we will go on to that.

Q268 Nadhim Zahawi: A quick question to Chris. You are a member of the Kay Advisory Board. What advice did you give Professor Kay about the balance between voluntary best practice and formal legislation?

Chris Hitchen: All of us agreed that, if you can get the market to produce good solutions, that is usually preferable to regulation. However, we did feel there were areas where the market has had 30 years of going in the wrong direction, as we have said, so some Government nudging to push it back in the other direction is probably necessary at this point. There are 17 recommendations in the Kay report. A few of them ask Government to do things, but there are actually more that ask other people to do things. Government should do the things that we asked them to.

Q269 Nadhim Zahawi: What recommendations fell away from the 17 that you may have discussed that you would want the Government to do?

Chris Hitchen: Where did we fear to tread?

Nadhim Zahawi: Slightly.

Chris Hitchen: As I have already said, we only had limited time. Professor Kay in particular spent a year of his life on this but did not have any more time to

spend on it. One area that perhaps does not come out as much in the report, although it is there, is around the potentially perverse effects of high-frequency trading and what happens on the sell-side. Around the table we were reasonably well disposed towards a financial transaction tax, which might help to mitigate that. We did not pursue that, but it is something we definitely picked up.

Q270 Nadhim Zahawi: Why didn't you?

Chris Hitchen: We had limited time and we were also aware that it might be an area that would need quite a lot of work with Government to get all sides of Government lined up behind it. I am not an expert on this matter.

Q271 Nadhim Zahawi: That is not a good reason for not pursuing it—that it required more work. You could have suggested that that is what needs to happen.

Chris Hitchen: Sorry. Professor Kay has already been before you, I think, and has probably already touched on this issue. We were minded to think it was a good idea. There are problems with imposing any sort of tax on a partial basis in a global market, so that was one reservation we had. Frankly, we were also aware that there was a potential short-term detriment to UK plc in doing things to hurt the City, and we had to be cognisant of that.

Neil Woodford: We already have a financial transaction tax.

Chris Hitchen: We do on end investors, but not on professional investors. It is the wrong way round.

Neil Woodford: Yes, it is the wrong way round.

Q272 Nadhim Zahawi: So you are in favour of a financial transaction tax if it is implemented globally. Is that what you are saying?

Chris Hitchen: It could potentially take a lot of unnecessary trading out of the system. Who pays for the profits of traders? Ultimately it seems to me it is the end investors; it is my members. Even if we end up paying a small tax on the trades that we do, if it stops us paying for a lot of profits on other peoples' activities, then we are still better off, net-net. That is my view.

Q273 Nadhim Zahawi: Do the rest of the panel share that view?

Steve Waygood: I would be very happy to say "yes". We only agree that the financial transaction tax is a good idea if it could be done simultaneously in all key financial jurisdictions. Unfortunately the political practicalities of that mean that it might be an academically good idea for Tobin 30 years ago, but the current manifestation of it is not something that we would support.

I hope what I have been very clear about is our recommendation, which is similar in a sense, that we should use the existing commission. So not just have the commission there to sit as a brake on the system, but also hypothecate the commission itself, so that you are funding better stewardship. In fact, for me, there is nothing de facto that hypothecation will happen with the revenues of the FTT, and in fact the treasuries around the world have a very poor record on

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hypothecation. So that is one of the other reasons why we are not in favour of the FTT.

Chair: I am getting a lack of enthusiasm on the FTT.

Neil Woodford: It is going to be really hard to get the universal outcome that we want, so disproportionate FTTs would be damaging, potentially.

Q274 Nadhim Zahawi: Just very briefly, Chris, you mentioned the recommendations from Kay. Which ones do you think most naturally lend themselves to formal regulation?

Chris Hitchen: At the risk of repeating ourselves, we did feel that the investors' forum required some sort of Government backing, if only to get over the perception that regulatory authorities would be against this sort of thing. One thing that was touched on this morning as well was the question of fiduciary duty, and the extent to which that can be forced through the investment chain. At the moment it applies at my end

of the chain but it does not apply at the transactional end, and Government intervention may be required to prevent it being stopped from going down the chain by contractual arrangements. Those are the two I would cite.

Chair: That concludes our questioning. It is has taken rather longer than I expected. Thank you for your contribution. That is incredibly helpful, and I will finish as I finish with other panels by saying that, on reading the transcript of this, we may feel there are further questions that we would like to ask. We would be grateful if you could respond to them. Similarly, you may feel that there are questions that we should have asked but did not or that you would like to supplement the evidence you gave—feel free to write in to us. It will be incorporated in our final report. Thanks very much. Can we have the next panel, please?

Examination of Witnesses

Witnesses: **Daniel Godfrey**, Chief Executive, Investment Management Association, **Guy Sears**, Director, Institutional, Investment Management Association, **Penny Shepherd**, Chief Executive, UK Sustainable Investment and Finance Association, and **Matthew Fell**, Director of Competitive Markets, Confederation of British Industry, gave evidence.

Q275 Chair: Good morning, and thank you for waiting patiently. I apologise for the delay. One of the reasons for that is we had rather more questions for the previous panel than we have for you. However, that does not mean the responses you give may not generate further questions. Could I just start, as I did with the other panel, by asking you to introduce yourselves, and the organisations that you represent, for voice transcription purposes?

Guy Sears: I am Guy Sears. I am Director, Institutional, of the Investment Management Association.

Daniel Godfrey: Good morning. I am Daniel Godfrey, Chief Executive of the Investment Management Association

Penny Shepherd: I am Penny Shepherd. I am Chief Executive of the UK Sustainable Investment and Finance Association.

Matthew Fell: Good morning. I am Matthew Fell, Director of Competitive Markets at the CBI.

Q276 Chair: Thanks very much. I will just remind you, in case you were not here, of what I said to the previous panel. Some of the questions will be person specific, others will be general. Please do not feel that you all have to respond to every question if you feel that there is nothing really that you could add to what has been said by the previous speaker.

Can I start with a question to you, Penny? I will try to abide by my own strictures this time and be disciplined. In your written evidence, you state that UKSIF's aim is to "seek to ensure that individual and institutional investors can reflect their values in their investments". If Kay is successful, can you take your P45?

Penny Shepherd: Well, I am planning to take a P45 anyway. UKSIF supports financial services that

advance sustainable development. We see an effective market in good ownership practice by investment managers as an important way of ensuring that investment services can effectively advance the public good as well as meet the needs of their clients. That is in part about enabling people to invest in line with their values, but it is not only that.

It is fair to say that, increasingly, investors are looking at environmental and social and governance issues, because they give additional insights into financial returns and because they are increasingly material to the success of a company in long-term value creation. Ultimately, we are interested in stewardship because we see a greater emphasis on stewardship as a necessary technique for ensuring that capital markets serve the public good.

Q277 Chair: From your different perspectives of the equity market, what do you see as its primary function and its different players? Who would like to lead on that? Daniel, you look as if you have got a response.

Daniel Godfrey: The primary function of the equity market is to get capital from people who have it to people who need it in an efficient way. As to the role of the different players, the role of the corporate who is seeking capital is to promote the success of their companies, and we would see that in a more holistic sense than perhaps has been the case in the past.

By that I mean that the success of the company is to have a sustainable, long-term supportable company that delivers not only returns to its owners but also opportunities for development and growth to its employees, plays a responsible role in the communities in which they operate and takes a responsible attitude towards the environment, and so on. In terms of the other players, the players go all the way down the chain to the individual investors and

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pension fund members who are providing, effectively, the capital that goes up through asset managers and through the buy-side in the market towards the companies.

Penny Shepherd: One thing I would add to that is one of the most significant things about the Kay Review is that it challenges that question of the primary purpose of capital markets, and it highlights that the purpose of capital markets is to meet the needs of the end users of the system, i.e. the company's need for capital on the one hand and the saver's need for appropriate returns for providing that capital on the other.

Over the last few years, the purpose of regulation of capital markets has been to ensure that the capital market works smoothly for the participants in the market. So it is a really significant shift from, "Does the engine work smoothly?" to "Does it actually get you from A to B?" That is a really important difference.

Q278 Chair: A previous witness—I think it was Lord Myners, and I am paraphrasing him—said, in effect, "Is the City here to serve the economy or is the economy here to serve the City?" What is your view on that? Penny, from what you said, I gather you think that regulation has reinforced a self-serving element of the City. I may have misinterpreted that, but I think Daniel wanted to respond first, and then Penny wanted to come in.

Daniel Godfrey: If you take the purpose of investment management, the relationship there is that clients, whether they are intermediated or direct, effectively give asset managers their money and trust them to use their skill, knowledge and experience to invest it in a way that will deliver them returns in a risk-appropriate fashion. Asset managers do not take money on to their own balance sheets, and that gives them a fiduciary purpose that they need to always be aware of.

I would say very much that the purpose of asset management is to look after the interests of clients, to allocate capital efficiently throughout the market and to do the best possible job they can. You asked whether the economy is there to serve the City, and I think there is no doubt that there has been a lack of balance in the relationship between society and the City in recent years. That is something that the industry, the Government, the regulators and society need to sort out, and this is part of that process.

Guy Sears: On the equity markets and Kay saying, "Do they actually serve the purpose?" there is a distinction in language. The equity market as an economic whole is there about the allocation of capital. The precise mechanisms used on the trading venues at the moment and in the structure of the stock markets—I think this is one of the things Kay talks about—are as much intermediaries with their own incentives as any other part of this chain. Sometimes they are not seen in that way, but they are. They have incentives that maybe drive tariff into types of trading that are not really serving this longer term interest.

Matthew Fell: I would just endorse what was said on the role. The provision and efficient allocation of capital has to be at the core of the function, and on

the second issue the answer surely has to be that the City is there to serve the economy.

Q279 Nadhim Zahawi: We have heard that it is common practice for fund managers to vote on company matters without consulting their shareholders at all. Does this practice need to change?

Daniel Godfrey: There are a wide variety of different clients. You are talking about whether they consult their clients and end users about how they vote. Clearly, it is the right of a client to tell their supplier how they wish that relationship to be governed. If a major pension scheme says to a fund manager, "We want to dictate how you vote on any issue," then the supplier should say, "Absolutely, yes. But, of course, we want that to be taken into account when you measure how well we have done, because if you have voted yes on something that we would have voted no on, and then the whole thing has gone pear-shaped, do not come along and kick us for the underperformance of that holding." That is just the nature of commercial relationships.

You got into a bit of a debate with Neil Woodford about consulting the hundreds of thousands of individual investors. There is a demarcation between communication and control. It would be utterly impractical and probably not a great thing to set up some sort of internet voting mechanism, where every one of Neil's hundreds of thousands of clients could push "yes" or "no", and Neil would then vote accordingly. I do think that communication with your customers about what your process is and what you have actually done in principle is absolutely the right thing to do, and we should seek to move that forward. I was interested in that part of the debate, because it must be 25 years ago that I set up one of the first ethical investment unit trusts in this country. Around that trust we put together an independent panel to look at the investments that the managers were making to see that they met the criteria, and we did have an annual general meeting whereby investors could come along and complain: "You have bought this company and they sell tobacco somewhere," or whatever it was. I felt that engagement was very helpful.

I think engage, yes, make decisions, no. In principle, when you hire an asset manager you are delegating to them the responsibility to buy and sell investments. Part of that probably should be by and large the engagement and the buy/sell decisions. Otherwise, how do you measure their performance? We need to have a much better understanding; we need to have much better practice; we need to have much more frequent practice; but ultimately you as a client should be choosing an investment manager because you like the way they do it, rather than trying to stand on their shoulder and dictate voting for them

Penny Shepherd: Building on that, in many ways I would endorse what Steve Waygood was saying earlier—that the key issue is around demand and around valuing good active ownership by investment managers. In many ways your question might be reinterpreted as the value of representative democracy versus the value of direct democracy.

At one level, to throw the question back, I would ask how helpful is it when your constituents tell you

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exactly how they would like you to vote on a particular vote in the House. The answer is that you are probably glad that they are showing an interest in the particular issue—you are glad that it is showing demand for your services as a representative—but at the same time you probably recognise that you have a depth of knowledge of that particular issue that not all the individuals who are telling you how to vote will have developed.

What we are concerned about is increasing that demand. One way UKSIF is seeking to ensure that is by co-ordinating the UK's first Ownership Day next week to raise awareness of the issue, because we are really conscious that, if you read the personal finance pages, it is all about how to pick a good stock picker. It is never about how to pick someone who is good at stewardship. I mean even if you look at the press coverage around Neil Woodford, it is very rarely about Neil Woodford as an active owner; it is much more about Neil Woodford as a stock picker. That is typical of the environment at the moment.

However, what we are saying in Ownership Day is, "Ask your fund manager what they are doing, because in many ways they are the experts." What our fund management members say to us is, "If an individual emails us and says, 'I would like you to vote a particular way with my shareholding,' actually that is welcomed." It is a demonstration of interest and not a lot of emails like that get sent—considerably fewer, I think, than the emails you receive about individual votes in the House.

Daniel Godfrey: You have reached the real nub of it in many ways when you talk about demand, because demand ultimately will be driven by belief, and the belief needs to be as to whether it adds value. Are we going to get better long-term outcomes by having good stewardship and engagement, or are we not? I guess your belief is that we will; I believe that we will. The evidence shows that we will.

But until the clients believe it, and believe it is worth paying to get it, what you are going to get is some people who really believe it, as you saw with Aviva, and who do it that way because they believe in it, and other people who do not really believe it going through the motions. That is why you get the box ticking and the boiler plating and the establishment of a patina of activity to defer attention from the press or the regulator or Government or politicians. That is why there is a very big education process required to bring people into the tent to put the spotlight upon them, and to convince people that this really adds value for the longer term. Otherwise, it is not going to really work.

Q280 Nadhim Zahawi: The reason why this is an important issue, and I will come back to Penny's point about reversing the question to us, is that some will do it really well. It is a bit like this place, where some politicians have embraced the new technologies and communicate with their constituents regularly and consult them regularly on how they should behave in this place. That is a good thing, and the same thing will probably happen in your industry, in the sense that those who will do it really well will flourish and do well in the new world. Those who do it badly will

be found out, and those that do it as a box-ticking exercise will also be in a less comfortable position.

In terms of reversing, I slightly disagree with you. Yes, of course, demand is a challenge, but it is how you communicate in the first place—how you consult. I do not think it is a black and white issue of either saying, "Well, we are going to let them vote the shares and I am going to behave the way they want me to," or, "I just send them communications," as a one-way broadcasting exercise.

There are many more innovative ways today, whether in politics or in your industry, of consulting properly, i.e. setting the rules out to people saying, "Here are the trade-offs; here are the things I am thinking about"—because they are ultimately the experts—"What do you think?" Then the data comes back to you, and then you can act on that data. I do not believe you should not act on the data at all, and you should just say, "Well, they have bought into me because I am the expert and that is it." There are many better ways of doing it than this—forgive me for saying this—sort of old-school thinking.

Chair: I think we have got the message. Could you respond?

Daniel Godfrey: I think we agree that communication should be two-way, and it informs your decision-making just as your constituents may inform yours, but ultimately they have elected you to come to the House to cast your vote according to what you believe. It is a very good analogy to the fund manager, and the two-way communication needs to exist.

Penny Shepherd: Can I just add one brief point to that? One area in which this House can act to raise awareness is by acting as an exemplar of good practice. In particular, I do hope that you will encourage the Parliamentary Contributory Pension Fund to be an exemplar of good practice in this area. I certainly think from my understanding that there are opportunities for improvement there.

Nadhim Zahawi: That is a very good point.

Chair: That is very well put, if I may say so.

Q281 Nadhim Zahawi: My final supplementary: obviously, part of the problem is that fund managers have so many companies on their books, so practically how can we combat this over-diversification do you think?

Daniel Godfrey: The investors' forum could potentially be a way of helping with that. I recognise that it is very hard to get a consensus amongst investors, as Neil Woodford told you earlier. There are examples, for instance in Holland, of where organisations come together effectively to syndicate from the buy-side their research on stewardship and engagement and governance, so that you can spread the load across a broad number of investors. That could potentially be a role for the forum that Chris and Professor Kay had not envisaged.

In our discussions with investors, although it is not a universal theme, that has been raised by a number of them. People are saying, "Look, we cannot bring our A-game to every company that we own, because we just own too many of them. Is there some way in which the forum could enable us to come together to spread the load, so that the people who have either the

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highest motivation around a particular company or the greatest skin in the game could effectively be deputed under a philosophical framework about what good engagement and stewardship looks like, so that we can trust them to go and ask the right questions?"

Guy Sears: A key point, so it is explicit in what Daniel is saying, is this is about mechanisms for addressing the consequences of diversification, rather than suggesting people should not be diversified. It is very important we do not forget that the economic advantage of being diversified in a fund and suchlike is a very considerable one. There is just a cost that comes with it, and we are trying to address that cost, rather than suggesting you should not be diversified.

Q282 Mr Binley: A simple question to Mr Godfrey, primarily. You have launched a discussion about setting up the investors' forum. Can you tell us what progress you have made?

Daniel Godfrey: Yes, certainly. I would say there have been varying shades of enthusiasm as we have discussed it around the industry. We have tried to talk as broadly as possible, because we recognised one of the very valid points Professor Kay was making was around the fact that a decreasing proportion of the UK market is owned by traditional UK institutional investors. Foreign investors and sovereign wealth funds own an increasing proportion. We have talked to insurance companies, pension funds, investment managers, sovereign wealth funds and foreign investors. As I said, there is probably a spectrum of enthusiasm that ranges from highly enthusiastic to pretty much opposed to doing anything.

There are grounds to say there is already a lot going on; there are a number of informal forums that do work in some circumstances at getting people together and making things happen. The view that we expressed in November was that we felt that a formal mechanism with a thin layer of resource to actually drive the thing forward and do some of the heavy lifting would help. I would say that the majority opinion, in my view, would be fairly lukewarm support for the idea that, if we do not give this a really good go, we will never know whether we can make it work or not. We will seek to proceed from there if we can over the next few weeks.

Q283 Mr Binley: I am delighted by your display of enthusiasm; it is very commendable. You talked about foreign investors and sovereign wealth funds. How many foreign investors and wealth fund people have signed up?

Daniel Godfrey: We are not asking people to sign anything at this stage.

Q284 Mr Binley: So you are still in the preliminary stages then?

Daniel Godfrey: Yes, we are still in the preliminary stage of seeing if we can establish a sufficient consensus to bring forward some concrete proposals to make it happen.

Q285 Mr Binley: What is your target date for the first meeting?

Daniel Godfrey: The target date for deciding whether we have a sufficient consensus to move forward to the next stage will be over the next few weeks. What I wish to do then, if we are able to move it forward, is put this in the hands of actual investors—to take it away from the bureaucrats within the trade associations—to take forward the ideas and the information we have gleaned over the last few months and to ask them to take this forward to the next stage. But we would provide the secretarial and, if necessary, financial support to make it happen.

Q286 Mr Binley: What would be your target for setting this thing up, rather than talking about it? I admire your enthusiasm, but I want to know when it is going to happen.

Daniel Godfrey: If we are able to move this forward, I would think in the next four or five months that you would want it to be up and running.

Q287 Mr Binley: We shall track that, and that is encouraging. Can I just ask one final question? Lord Myners was pretty scathing, and the fact that you mentioned you want to hand it over to the trade, as it were, as opposed to trade organisations, suggests that you read those remarks. But if you did not, let me read out his fear: "What we will end up with is a forum that is dominated by trade associations, and trade associations' modus operandi—their purpose for existing—is to protect the status quo."

Daniel Godfrey: I could not disagree with Lord Myners more. I agree with him, though, very much.

Q288 Mr Binley: I will write to him and tell him that.

Daniel Godfrey: You do not need to; I have told him myself.

Q289 Mr Binley: You have done it yourself?

Daniel Godfrey: I have told him myself. Our vision of what is needed is actually quite similar, and Lord Myners has a very good way of expressing himself.

Q290 Mr Binley: You thought he was being naughty, did you?

Daniel Godfrey: I would not say that. I have seen worse.

Q291 Chair: There were elements in your response to Brian Binley's question that smacked of Sir Humphrey. Having a consultation to achieve a consensus and then moving it on. I mean are you actually driving this process with any sense of conviction? Was it delegated to you to take on—not you personally, but your organisation?

Daniel Godfrey: I had only been in position for a very short amount of time, so this is something very much I wanted to grasp, because it is something that I strongly believe in. There is definitely a sense of conviction behind this.

The subject of stewardship and governance needs to be elevated above the primary focus on issues around the board and issues around remuneration, which I acknowledge are very important. We need to look at stewardship as being around a real understanding and

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support by investors of companies' long-term strategies for sustainable shareholder return. It needs to be about understanding and support of the companies' management as being people who are capable of executing the strategy. It needs to be around an understanding of the companies' financing models, so that they have the resources necessary to execute on the strategy.

That is all very clear, but to get to your question, it is not easy, because there are a lot of different views. As Neil Woodford said, if you have 10 investors in the room, you will probably have 12 different views. I have to be quite careful in terms of how we move this forward to try to get sufficient people coming with us, because if you do announce something and no one wants to join in, it will be a missed opportunity. When you say you will track us over the next few months, you probably will not have to wait that long, because I think in terms of the work we are doing, it will either move it forward or kill it quite quickly.

Q292 Mr Binley: I was rather more gentle about my approach to you on bureaucracy than perhaps the Chairman was. That is why I asked you some closed questions, which I think you answered with alacrity. You did say that things should be set up in five months. Will you keep us informed?

Daniel Godfrey: Absolutely, yes. I think we will be back to you pretty well before then, because we will either be moving forwards with real intent or we will be saying our efforts have failed.

Mr Binley: We look forward to your regular updates.

Q293 Chair: One thing you did not answer was my question on whether the Government asked you to take this forward.

Daniel Godfrey: No. Well, the Government has encouraged us and others to try to produce a substantive and principled response to Professor Kay's recommendations. I do not think ours is necessarily the only game in town, but they are certainly supportive of what we are trying to do.

Q294 Julie Elliott: Matthew, from a British industry perspective, how will the investors' forum improve relationships between the players that are in the market? Do you think it will?

Matthew Fell: The notion of better engagement, better depth of understanding and better research on companies should over time lead to increased scrutiny and performance. Therefore, if you are able to both increase the breadth and depth of that research and understanding around companies, which the investors' forum seeks to do, that is a good thing. There are two challenges in it that will need to be overcome. The first is particularly on the investor side, if you like. How are you going to have a forum that is broadly sort of working in the same direction and striving for consensus on the one hand while all investors are trying to do the sort of value picking that we have heard about previously? How do you retain that degree of competitive edge within an environment of collaboration and consensus? That is a challenge to meet on the owner-investor side.

From the companies' perspective as well, the companies that are really up for good and proper engagement with shareholders will tell you they would like some of the different lines of questioning and some of the challenge that comes from different areas of their shareholder base. They would feel it a retrograde step if that was diluted and it was all condensed into just one view and one approach from the forum. Maintaining a sort of diversity of challenge on both sides is really important, but the overall notion of the forum is a good thing if it can add to a depth of understanding in research.

Q295 Julie Elliott: Thank you. To everyone here, who do you think are the essential people that need to be involved in this to make it work? Are they engaging with you?

Daniel Godfrey: The essential people are the investors themselves. To me, that would be the people making the buy/sell decisions within companies, but different investment managers are structured in different ways. So in some companies it will be the governance and engagement specialists as opposed to the actual heads of equities or chief investment officers or portfolio managers. Are they engaged? Yes, absolutely; they are engaged but, as I said, there is a broad range of opinion.

Penny Shepherd: The thing I would add is we see three particular groups within the investment industry practicing engagement. It is important that there is access to the investors' forum for all of them. Those three groups are, first of all, active managers of equities. As you say, they may be structured in different ways, but essentially they are people who make buy and sell decisions.

The second group are engagement specialists who are engaging on behalf of passively tracked funds, so on behalf of index-tracked funds. That is an important group as well. The third group are where asset owners have commissioned independent service providers to engage with companies on their behalf. So people like Hermes, for example; NEST uses The Co-operative Asset Management for that service; and so on. Similarly, it is also important that that group is involved.

Daniel Godfrey: I would agree with that, and if the forum is going to work, it needs to be as open to as many people as possible, because the broader it is, the stronger its voice.

Q296 Mr Binley: Kay recommended that companies should consult their major long-term investors over major board appointments. How I wish we had that ability in the House of Commons when it comes to the Cabinet, but sadly we do not. Why should companies consult with fund managers if fund managers do not consult with their clients?

Daniel Godfrey: There is an issue of delegation: firstly, fund managers will consult with their clients if their clients want it; secondly, fund managers, I think we have agreed already, could do more to engage in two-way conversation with their clients, whether they are large pension funds or small individual investors. But they have essentially been delegated to make these decisions.

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Board decisions can be quite significant. I would not disagree that companies should consult with long-term investors over board appointments, but I think it is “consult”; I think that ultimately boards make decisions and shareholders have the opportunity to express their concern or disagreement with boards. Ultimately, in the UK shareholders have a huge suite of tools at their disposal to make boards do what they want, or ultimately replace them if necessary.

Q297 Mr Binley: I dare not mention the name Fred the Shred, do I? We

might have had more input there, but that is another matter.

Daniel Godfrey: I think we have all learnt some lessons.

Mr Binley: I will not ask you to answer that one.

Matthew Fell: I was going to put an answer to your question in the context of clarity of the roles of the individual players in this. Absolutely, the shareholder’s job is to decide whether they buy into the company’s strategy and then to hold boards to account in discharging that. The board is there to set that strategy, and then to oversee it and delegate to the management the day-to-day running of the company. Shareholders will want to know and rigorously test the capability of boards to carry out and discharge that strategy, and that is why I think it is a good idea that there is that sort of engagement on key appointments.

Q298 Mr Binley: Let me just pursue Fred the Shred and the need for a sensible approach to the purchase of the Dutch bank. Would you have wanted more involvement in that respect? It has done the financial services sector immense harm.

Matthew Fell: From what I have heard on the investor side, there were attempts at engagement, and the view would probably be that there was not sufficient information and powers to genuinely hold the board to account in that scenario.

Mr Binley: That is fair.

Daniel Godfrey: I think investors would acknowledge that it was not their greatest moment. Having tried to convince the company that this was not a great deal, so many of them then voted in favour of the deal, and I think they would look back on this as something they need to learn from.

We can understand perhaps what was going through their heads at the time: “If we vote against this, it is going to destabilise the company and may impact on the short-term performance of the shares.” The lesson learned there is that we need greater ability to follow through, so there was a problem, I think, in that you would express your concerns to the company, and if effectively they put their hands over their ears, the shareholders sometimes had a tendency to say, “Well, we have done what we could, and now we get on with it.”

Q299 Mr Binley: With respect, isn’t it a question of greater scrutiny and wasn’t that lacking? I mean there is the very fact that he did not do due diligence to start with. Any company buying a company worth £100,000 would do a degree of due diligence. Isn’t

this a question of scrutiny and isn’t that a factor that your forum needs to take into account?

Daniel Godfrey: This is an area where a forum could play a very significant role in ensuring that there is follow through, rather than momentum dissipating in the teeth of opposition. Yes, I would agree.

Guy Sears: I do not want to take anything away from what Daniel says. Clearly, there were responsibilities on our side, but also in this particular case, as with others where great damage can be done, these are regulated entities. There is also a different approach now by our financial services regulator that also is beneficial in terms of judgment on judgment. That is not to take anything away; I am just talking about the context of dealing with regulated entities.

Q300 Mr Binley: The words “light touch” come to mind.

Guy Sears: I do not think we are living in that environment now.

Q301 Mr Binley: Can I move on? That was a bit naughty. Professor Kay made a clear recommendation that quarterly reporting obligations should be removed from companies, something that I agree with. It is part of the over-regulation of processes. But I am really concerned about the quality of company reports, as many of them hide much more than they ever tell you. Do you feel that there is also a role there for further scrutiny? It seems to me that company reports are often meant to obscure rather than illuminate.

Daniel Godfrey: Without going into motivation, obviously, they could be. There is a real problem with company reports. The introduction of International Accounting Standards has unfortunately made things worse. Accounts should be there to provide information to owners—to users of the accounts. The last place you would go if you wanted to find out about the company now, almost, is the report and accounts.

Mr Binley: That is the problem.

Daniel Godfrey: So, yes, there is certainly scope for further scrutiny, and I am glad to see the FRC is now acknowledging that the introduction of International Accounting Standards has not perhaps improved the clarity with which people can understand the report and accounts, and that is greatly to be regretted.

Q302 Mr Binley: I understand that, but they also need scrutiny. I do not want to create a great big bureaucracy in the forum, but I do want to see some incisive thinking that really impacts on your clients.

Daniel Godfrey: We take corporate reporting and the quality of corporate reporting very seriously. We are very engaged in that. Whether it could become an adjunct of the forum or not, I do not have a view on at this stage. It certainly is an issue that investors need to be very engaged with, because it is clearly a huge amount of wasted time, effort and money to produce accounts that are of very little value, and it also provides disadvantage to investors who are not able to do work around the report and accounts to get a real understanding of companies.

Guy Sears: I do not think regulation would be the answer, and that is why the fora will hopefully be the

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answer. This will not be the only place in which we have documents that are legally comprehensive but utterly incomprehensible. That is a problem we get very often from regulation.

Q303 Mr Binley: So it is on your little list?

Daniel Godfrey: It certainly is.

Penny Shepherd: The area specifically of non-financial reporting—of environmental and social governance reporting—is an area on which investment managers have engaged with companies to improve performance over the last few years. But it is also an area where investors have worked with companies to set standards, so that you can have more comparable reporting. Ultimately it is not just about understanding the company; it is also about being able to compare it with its benchmarks.

Q304 Mr Binley: I understand that, so can I put words into your mouth? It would be better to have a sensible six-monthly reporting process, rather than a totally unreadable quarterly process.

Penny Shepherd: It is fair to say that quarterly reporting is on its way out. It has been recognised as a blind alley. If you look back at when the European Commission introduced quarterly reporting, it is interesting to see the positive effects it was expected to have. The fear is that, when the legal requirement for quarterly reporting is removed, companies will continue to do it if they get pressure from short-term investors to do so.

That is an area where long-term investors can play a positive role in saying, “No, we are not interested in the quarterly figures; we do not want you to focus on those. What we are interested in is the long-term story and, yes, key metrics but also forward-looking reporting around what you see as the key opportunities and threats for your business, and what you are going to do about that, so we can assess the quality of you as management and we can assess the likelihood that your strategy will succeed.”

Matthew Fell: We agree that quarterly reporting does not add value and it should go. In terms of your question around annual reports obscuring the real story, I do not think there is a motive for companies to do that.

Mr Binley: I think sometimes there is.

Matthew Fell: I would disagree for annual reports, almost for the very reason that Daniel alluded to—that annual reports do not do anything to move markets at all now. It is not the place you go to really get into the report.

Q305 Mr Binley: Your comment is that you do not think they are sometimes written to obscure. I do not believe that to be true.

Matthew Fell: The major motivator there is a big sense of frustration. The sheer volume of stuff that is required to go in there turns them into doorstopper reports and makes it hard to find the data.

Mr Binley: You have a higher regard for some of your members than I do. Let us continue.

Matthew Fell: The third thing I would like to say on the narrative reporting is that a shift in that direction

would be a really good thing for driving better engaged and better quality investment decisions.

The one thing I would say on Penny’s remarks about the benchmarks and so on is it is very important that, if we do have this move towards narrative reporting, which would be a good thing, we make sure we do not get into a situation where companies have to report against particular benchmarks. The really important thing about narrative reporting is that companies are able to properly set out their strategy and investors can decide on that, and the different sort of emphasis that you will put in different narrative reporting could vary dependent on the nature of the company and the sector that you operate within.

Penny Shepherd: Briefly, I would add two issues. One is forward-looking narrative reporting. The other one is around key sector-specific metrics to assess companies, for example the health and safety metrics in the extractive industries. That is what I am talking about there when I talk about numbers.

Matthew Fell: You would put a bigger emphasis on companies in that environment.

Chair: You are in danger of having a discussion among yourselves.

Mr Binley: Thank you Chairman. I am just relieved that Daniel has got it on his little list, so we will see how that progresses.

Q306 Rebecca Harris: Penny, you commented that the way forward for Kay involves a lot more cross-departmental work on stewardship. What is your sense of the real level of appetite for change in Government?

Penny Shepherd: What I noticed with many Government consultations is that arguably there tends to be a focus on those organisations associated with the Government Department that has commissioned the review. So to give you one example, if we look back to the Walker Review that was commissioned by the Treasury and by the Financial Services Authority, which looked at the governance of banks and other financial institutions, what was quite noticeable was, yes, it commented on the governance of banks, but it did not talk about the governance of pension funds. Improved governance of pension funds is a significant driver of better capital markets. That is just one example.

If we look at the departments involved in this area, we have the FCA, the Financial Reporting Council, and The Pensions Regulator. We have DWP overseeing pension funds, the Cabinet Office overseeing charitable investment, and Communities and Local Government overseeing the Local Government Pension Scheme. This does not look like the most effective structure for getting things done. It would be very helpful if you were to look either at more co-ordination, at the future direction of relationships between regulators, or even at issues like centres of competence in Government to look at some of these issues, rather than having them spread so widely.

Q307 Rebecca Harris: The Government is proposing to publish a progress report in the summer of 2014, so less than 18 months away. What would

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you see as the absolute minimum that needs to have happened by then in terms of the Kay Review?

Daniel Godfrey: The industry needs, in whatever way, to step forward in a very substantive and principled way to advance the cause of long-termism. A part of that could be the investors' forum. A part of it could be the way in which investors engage on an individual basis. The point was made earlier by Matthew around the quarterly reporting, and in a sense that falls away as being an issue if investors are truly able to give boards the confidence that they are looking at them and measuring them on a long-term view.

We cannot ignore, and it would not be appropriate necessarily to demonise, different forms of investment management. But I think as a society and as a Government, what you want to encourage—because it is good for the economy and good, therefore, for the welfare of the citizens of this country—is a long-term approach and long-term investment. That is why this sort of hearing is very valuable, and so we need to step forward and give boards the confidence that they do not have to think over three-month timeframes and can take long-term decisions. This will drive the economic growth that you are looking for.

Guy Sears: I would only add that they are just layers and layers. Of course there are these high points, and then you have to ask whether they are individual barriers, and there are issues around conflicts of interest and the incentives that arise in our industry. I think Aviva mentioned the role of investment consultants in reviewing and determining these things over a short-term period.

In terms of the measure of success, I suppose we had hoped that, in terms of regulation and the duties expected, that would be coherent across that chain. So even if people think the chain is too long, it would at least be coherent. At the moment, different parts of it are either regulated or unregulated—different parts have different duties imposed on them.

Penny Shepherd: Looking at the demand side in summer 2014, what we have at the moment is some asset owners, like pension funds and insurance companies, supportive of the Stewardship Code and getting to grips with how they hold their investment managers to account. I certainly hope we see considerable progress in the thinking and development of that work.

More generally, I hope we see considerably more asset owners signed up to the Stewardship Code. It strikes me that there are particularly three groups that one would hope we would see considerably more progress on. First of all, we would hope to see pretty well every Local Government pension fund signed up to it. Secondly, we would hope to see considerably more corporate pension funds signed up to it, because one group that is notably absent in this area are the pension funds that are influenced by large companies. We are starting at last to see some movement on that, but there is still a considerable way to go. I would certainly hope the CBI would encourage their members to influence corporate pension funds, DB and DC, to have considerably more signatories to the Stewardship Code, and then effective implementation of that by summer 2014.

Finally, it would be so nice if by then the Parliamentary Contributory Pension Fund had signed up as well because, as of this moment, my understanding is they have not.

Chair: Thank you; that is very illuminating.

Q308 Katy Clark: Penny, you wrote that there is a clear role for Government to play in acting in a co-ordinated fashion to reform equity markets. Where do you think we are on that at the moment?

Penny Shepherd: One of the challenges of the Kay Review is that it has been commissioned by BIS, and ultimately the Government department with the greatest influence over equity markets is the Treasury through the FCA, and so ultimately one measure of success in that area is when we see the same level of commitment to long-term investment by the Treasury and its Ministers as we are currently seeing from BIS.

Q309 Katy Clark: In 2001, Lord Myners said that "it is important at least to attempt to seek an effective approach which does not rely on direct Government intervention in banning or directly determining behaviour". Ten years later, Professor Kay continues with that theme. Isn't it now time to formally regulate the market and, if so, which areas do you think more naturally lend themselves to formal regulation and which are better suited to voluntary compliance?

Guy Sears: The equity markets, just so we are clear, are subject to a massive amount of European-derived legislation through the dreaded MiFID, which is being revised at the moment. One of the difficulties with the regulation is it is designed around secondary market trading.

The real demand, I would suggest, in the thing we have been discussing is about primary markets—about raising capital. So we have driven ourselves through legislation and through incentives into a world in which the primacy of activity is secondary market trading. Kay and others have asked the question: where are the primary markets and where are those activities? That is a huge challenge on a pan-European basis, and it is a huge challenge that is going to be very difficult to address, because at the moment our whole focus really is on secondary market structures, things like high-frequency trading and the roles of alternative trading venues that London has and maybe continental Europe does not. From that point of view, that is very difficult.

If you then say the balance is between regulation and non-regulation, if I may be simple about it, good regulation ought to allow firms and participants to distinguish themselves—to show themselves as offering different service offerings from others but also to rise up in terms of standards. Getting that balance between prescribing, such that there is no difference in behaviour across the whole market because it is so prescribed, and opening up the market, so that you can compete more and show different offerings, is a very difficult balance.

To have that balance, we need to be trusted to ask for less regulation. We need to be trusted, and there is a trust issue with financial services generally. We need to move forward on that in terms of building

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confidence for us to then be able to turn round and say, “We do not need to be regulated so much.”

Q310 Katy Clark: The point I was making is it is 10 years on—in fact, it is more than 10 years on. How much longer should you be allowed?

Daniel Godfrey: If you are talking about how we create more frequent and higher quality stewardship and engagement, almost any regulation you try to bring in will not have the impact you want it to have, because it is a very touchy-feely part of business: how you engage, what you derive from it, what actions you take as a result, and what happens to the companies as a result. We can put in place things that make it look like things are happening really easily through regulation, but real progress will come from belief—people believing it will work—and also pressure from the demand side because they believe it will work, and that is entirely achievable over a period of time. You have to start somewhere.

What you will get, and what you have already seen happening just in response to the pressure from Government, is the establishment of an industry around governance, some of which works very well but a lot of which is around box ticking and boiler plating, which frustrates the heck out of the CBI members, because they get guys coming to them with clipboards, and creates a fiefdom within asset management companies. Although some of it is done exceptionally well, some of it is really cost and time wasting, and does not produce the results you want. I can almost guarantee that, if you try to regulate this, you will just get more of that.

Penny Shepherd: One of the things that John Kay calls for are effective incentives that encourage the

investment chain to do the right thing. What we think he is rightly very concerned about is rules that seek to force compliance when actually the interests of the members of the investment chain run counter to complying. That creates a market in pretending to do things and not getting caught. In a way the danger has been over the last few years that the incentives have been to not get caught, rather than actually to do the right thing.

Creating a market in doing the right thing comes down to two particular things. One is the quality of demand and addressing the quality of demand, and the other one is ensuring effective innovation and effective competition in the market. One of the worst things that could happen is the creation of a barrier around the market, so that only the current players can afford to play and new people find it difficult to come in and challenge them because of the way the regulation of the market has been set up.

Matthew Fell: I agree with much of that. On the balance between regulation and advocacy, if the task in hand is really to drive up high-quality engagement, I struggle to see how you actually generate those sorts of conversations through regulation, for all the reasons that Daniel outlined.

Chair: That concludes our questions. Thank you very much. I repeat what I said to the previous panel: if we feel on looking at the transcript that there are further questions we would like to ask you, we will write to you and would be grateful for a reply. Similarly, if you feel there are questions we should have asked you but did not, feel free to give your response in absentia. Thank you very much.

Tuesday 26 March 2013

Members present:

Mr Adrian Bailey (Chair)

Mr Brian Binley
Paul Blomfield
Mike Crockart
Julie Elliott

Ann McKechin
Mr Robin Walker
Nadhim Zahawi

Examination of Witness

Witness: **Rt Hon Vince Cable MP**, Secretary of State for Business, Innovation and Skills, gave evidence.

Q311 Chair: We are very slightly early, but I think we can get going. I realise that time is pressing for you, Minister, as well as ourselves. Can I thank you for agreeing to speak to the Committee on the Kay Review and welcome you? Just for voice transcription purposes, could you introduce yourself?

Vince Cable: I am Vince Cable, Secretary of State for Business, Innovation and Skills.

Q312 Chair: Thanks very much.

I want to start with a fairly general question. You may remember these words: “And the principles of responsible ownership should apply across the business world...So I am shining a harsh light into the murky world of corporate behaviour. Why should good companies be destroyed by short-term investors looking for a speculative killing, while their accomplices in the City make fat fees? Why do directors sometimes forget their wider duties when a cheque is waved before them? Capitalism takes no prisoners and kills competition where it can.” That, of course, was your speech to the Lib Dem conference in September 2010. You set up the Kay Review as a result, in part, of that speech. Now I have the Government response to the Kay Review, and their responses will be: “working with the EU counterparts to end mandatory quarterly reporting”; “endorsing clear minimum standards of behaviour for all investment intermediaries”; “the Law Commission has been asked to review the legal obligation on intermediaries”; “encouraging industry to establish an Investors’ Forum”; and “endorsing Good Practice Statements for company directors.” We had the sound and fury of your speech and then the somewhat less robust response from the Government. Just how many prisoners of capitalism do you think will be released as a result of this?

Vince Cable: Probably quite a lot over a long period of time. As you know, a party conference does induce poetry that we perhaps lack in our everyday discourse, but I do not, in any sense, retract the principles that I was talking about. We wanted to be guided by evidence and therefore we asked a distinguished academic and journalist to lead this review—he was backed by an industrialist, Sir John Rose, among others—and he has produced a report that relies very heavily on cultural change, rather than regulation. This is done, essentially, by trying to ensure that the whole complex chain of equity financing becomes much more transparent and operates on the basis of trust, which had largely broken down.

If I can add to your general question at the beginning about what we are doing, of course it is not just the Kay Review. In addition to the Kay Review, we now have an industrial strategy evolving, which depends very much on accepting the long-term nature of investment in many of our key industries and the need to work on a partnership basis with them. We have changed the terms of reference of the competition authority, so it must have regard to long-term investment decisions. The system of executive pay has been radically overhauled through Parliament and, again, that gives a longer-term dimension to decision making. Also, the takeover panel has reformed its activities, encouraged by us, not in dramatic ways, but in ways that will significantly address the issues I raised in the speech.

Q313 Chair: I think it is probably fair to say that the reaction to Kay was that it was very good on analysis, but weak on recommendations. I can see the problem from a ministerial perspective that it is very difficult to have bite on such a weak set of recommendations. Could you just say what the factors were that made you want to look into Kay, in particular, stripping out the conference rhetoric there? How far do you really think they will be addressed by the measures being taken by Government?

Vince Cable: The premise of your question is a criticism of Kay’s report, because it relies on voluntary compliance rather than regulation; I do not regard that as a criticism. These problems are complex and they do, ultimately, rely on a very complex financial system and a tier of intermediaries. There are limits to the extent to which either British or European regulation can address those failings. If they can be addressed by the industry itself, through good practice and through the investors’ forum—which is one of his key recommendations, through it is not a hard, aggressive regulation; it does rely on voluntary compliance—and if we can get that right, it will make a big difference over time.

You asked what prompted me to get into this whole field. It was the fact that when I came into this office, as you know, we had some pretty fierce controversies about takeovers and whether the time perspective was right. I was making factory visits to some of our leading engineering companies who were saying that they want to invest 10 or 20 years ahead, and they find it difficult to get the equity markets on the same wavelength; it was about how we address that problem. That is what led me into it. Although the arguments that come out of it do not involve a lot of

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mandatory regulation, it is not just analysis; these are good conclusions. What we now see happening is that the key players—such as the IMA, the investment managers, the pension funds and the insurance industry—are thinking very carefully about how to put this into practice and improve their good practice arrangements. We have had some very good statements in recent days from the Chartered Secretaries and from the NAPF—the pension funds—about how they are going to adapt their practices in the light of Kay, and that is good. We have also seen the European Union, which has major legislative responsibilities in this area, produce a green paper to guide its future work, which could have been written by Kay—it embodies all the arguments and principles.

Q314 Chair: One of Lord Myners' contributions was, in effect, to say he produced a similar report 10 years ago, and he did not feel that, shall we say, the culture had changed enormously as a result of that report. I am perhaps paraphrasing him. Do you really think, in 10 years' time, that the Kay Review will have resulted in a change of culture that will have actually delivered on the issues that you have outlined?

Vince Cable: I think so and I hope so. We are not letting the matter rest; it is not just a question of getting a report, sticking it on a shelf and vaguely hoping that people comply with it. We have made it very clear that in the summer or autumn of 2014 we want to go back over what the Kay Review has recommended to make sure that these things are actually happening. We are also commissioning a group of independent people who will track these recommendations and see that they are being followed through. You are quite right that there is always a danger of nice reports that just never happen. I did look over some of the evidence of Lord Myners. Essentially, when he came before your Committee, he started being quite critical of John Kay but, I think before the end, he effectively, while not retracting it, said, "Well, I've been actually a bit over-critical", and I think he concluded in his evidence to you that, basically, he had said the right things and come to the right conclusions.

Q315 Chair: Yes, I think he agreed that it said the right things. What he was concerned about was the political will to make recommendations arising from them.

Moving on, the equity market has seen huge technological changes in the past decade or so, and a lot of the evidence to this Committee indicates that that has actually given even more advantage to the institutional investor. Where, in the Kay Review, and the Government response to it, do you think there will be an enhanced voice of the owners of capital as opposed to the managers of it?

Vince Cable: Kay sees a chain going all the way back from the ultimate investor, through the chain, to the asset owners—the pension funds and the institutional investors—and wants to make sure that the distribution of costs is completely transparent, and that there is no abuse at various points along the chain and, therefore, there is basic trust. That set of relationships is set out very clearly. You make the point that we are dealing with important technological change. One of the things we are trying to encourage

in the Government—and, again, we have to work through European institutions and legislation—is to create a proper electronic platform, which is the way business increasingly will be transacted.

Q316 Chair: You referred to Lord Myners earlier and his evidence. One of his concerns was that arising from his experience when he did his review, he was subjected to intense lobbying from the financial services industry, and this was repeated when he was a Minister. Can you say whether you have been put under that sort of pressure?

Vince Cable: No, I have not. The financial services industry, particularly banking, has been rather humbled by the experience of the last few years and will probably be rather less aggressive now than it used to be. Far from being aggressively lobbied, I have actually sought out these groups to talk to them and get their feedback. Certainly within the last few months, I have been to talk to pension fund events and insurance industry events. I have met investment managers and tried to put to them the Kay Review arguments, in order to encourage them to set up this investors' forum, as well as talking about the more general long-termism agenda and trying to engage them in it. In answer to your question, no, I have not been subject to aggressive lobbying, and certainly nothing that I would want to complain about.

Q317 Chair: In terms of your dialogue with the industry, could you give us some idea of, over the past 12 months, how many meetings you have had with the representatives of the financial services industry and also with the representatives of "responsible" investment groups, such as ShareAction, UKSIF and FairPensions?

Vince Cable: I cannot produce an inventory, but we are talking about high single figures to perhaps a dozen—probably something of that order. Quite a few of these occurred in the context of the work that we did on executive pay, where we organised a series of workshops with key people in the industry, including the institutional investors. That was a separate exercise, but I did engage substantially with the industry on that set of issues. In parallel with that, there was some discussion on Kay follow-up.

Q318 Nadhim Zahawi: Secretary of State, just on that point, some of the response we have had from those industry practitioners is that some are taking this very seriously—we have had Fidelity, Aberdeen Asset Management, and others come before us. However, some of the feedback is that others are thinking, "This will just go away if we ignore it". What message do you have to those who just want this thing to go away?

Vince Cable: If they are going to avoid the opprobrium that has descended on the banking industry, they would be well advised to follow best practice. That is one of the lessons of recent history. There are initiatives opening up by their industry bodies—the trade bodies. Now, of course, as you quite rightly say, it is the membership that matters, not the trade bodies. The trade bodies have now set up a steering group to launch this investors' forum, which is at the heart of the Kay recommendations, and so I would strongly encourage them to participate in that and make sure it works. I would also strongly

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encourage them to listen to the statements of best practice that have emerged from the representative bodies in the industry, because that is how standards are raised.

Q319 Nadhim Zahawi: If they do not, is there a big stick that you can wield?

Vince Cable: We are not currently thinking of that and there is no obvious big stick to wave. There are certain specific problems, like remuneration, where we have introduced some sticks, and there will be European regulation under the UCITS directive and so on. That will be mandating, and our job in the UK Government is to make sure that that heads in the right direction. We are not waving big sticks and that would go contrary to the Kay philosophy, which was about building up trust.

Q320 Nadhim Zahawi: It has been pointed out to us that the Government are encouraging diversification—for example, tax breaks connected to managed ISA funds. This is an outcome that has obviously suited the fund management and banking industry very well. How do you see these incentives changing in the future?

Vince Cable: I am not sure we are talking about quite the same thing, but if we are talking about diversification—the building up of equity markets—there is a whole series of initiatives. One that you mention is using ISA products as a vehicle for, say, AIM equity. The Government, as you know, have scrapped stamp duty on AIM shares, which will help to diversify that equity market. There are discussions taking place with the Stock Exchange about how to improve entry to the higher-level FTSE, rather than the AIM market. A whole lot of initiatives are being taken to broaden out and deepen equity markets.

Q321 Nadhim Zahawi: On the Chancellor's announcement of the scrapping of stamp duty on AIM shares, how do you think that will affect your response to and the implication of the Kay Review?

Vince Cable: It is a useful step forwards. There was a very good report published recently by the think-tank Reform, which explained why that would make a key difference. We know that equity markets are defective right the way up the chain. From so-called friends, families and fools at the bottom, right up to the FTSE 100, there are gaps in the equity chain, and that will fill in one segment of the market.

Q322 Nadhim Zahawi: Similarly, for business, there appears to be a vast gap in the way different sources of finance are treated. Would you prefer companies to finance their growth through debt or equity?

Vince Cable: In general, I would share the view that the Chancellor and others have set out that our system does load incentives to debt, rather than equity, and it would be sensible and helpful over time to try to shift that. The problem is about how you do this through the tax system. You have got an enormous number of companies that are loaded up to gunnels with debt, and if you stop them withdrawing interest relief, you put them into even deeper problems, so we have got to work through the debt crisis before creating that kind of unintended consequence. However, if we can devise tax and other regulatory interventions, we certainly should be trying to make equity more attractive, relative to debt.

Q323 Nadhim Zahawi: That was going to be my follow up—interest payments on debt are obviously tax-deductible, whereas similar returns going to equity investors in the form of dividends are not.

Vince Cable: You know this area. There are considerable limits to interest offsets, but the principle is right, yes.

Q324 Nadhim Zahawi: Given your preference to move to equity finance, what representations have you made to HMRC and the Treasury on this, in relation to changes in the tax system and to rectify these perverse incentives?

Vince Cable: Not a great deal, but interventions like the AIM market and the encouragement of seeds-type activity are all part of that general approach, which we would certainly want to encourage.

Q325 Nadhim Zahawi: Can we go any further than that, or is that as far as the Business Secretary will take it?

Vince Cable: I will just mention one or two other things. We do envisage, with the business bank that is now getting off the ground—we put in a written ministerial statement last week explaining it—that quite a big component of that will actually be about equity development. It will not just be about loan finance, so that is something we did not expect when we got into it. We are now realising that that is where a lot of SMEs are trapped and we think we can do some quite creative work with the business bank on equity financing as well as loan financing.

Q326 Nadhim Zahawi: Absolutely right. Just on the Kay Review, who wrote the Government's response? Which Department and which officials wrote the response?

Vince Cable: There are officials in my corporate governance section—very good officials—who wrote it, and I, of course, looked over it before it was issued.

Q327 Nadhim Zahawi: Did any official involved in Professor Kay's team have any influence over the Government's response?

Vince Cable: Are you suggesting there is something irregular?

Nadhim Zahawi: No, it is just a question.

Vince Cable: No, there are some extremely knowledgeable officials who I respect and I listen to what they have to say. They know far more than I do about this subject.

Q328 Chair: If my memory serves me right, this arises out of something that Lord Myners said, when he effectively said it looked as if somebody on the departmental team had basically just reproduced what the Kay Review was saying and, effectively, they were marking their own homework.

Vince Cable: I met John Kay and his team several times when they were doing the report, and I did not get the sense that they were being led by the nose. John Kay is one of the brightest people around. He has written an extremely good book, which is widely used, on corporate governance, and he was very much developing his own ideas, rather than the views of my officials.

Q329 Mr Binley: You have been very kind to the members of this Committee in having met with us on this issue on two occasions so far, and we are very grateful for that, and that has been very helpful. You

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know our concerns arose out of the hostile Cadbury takeover, which we felt was a group of American pirates—if I can put it at its worst—trying to get hold of one of the jewels in the British industrial and commercial crown. I still remain of that view, actually, and I was hopeful that Kay might do something about this. Indeed, in your written evidence submitted to this Committee, you said that “the Kay Review seeks to shift the culture of UK equity markets to ensure they support long-term investment” and “constructive relationships”. The hostile takeover did not start off well, with regards to Cadbury in that respect. I wonder what you see in Kay at the moment to suggest that that situation will be improved for the future, should similar occurrences arise.

Vince Cable: It is fair to say that my interactions with your Committee started off with the takeover, did they not? As I said to you at our last meeting, the outcome has not turned out to be anything like as bad as was forecast.

Mr Binley: I think that is fair.

Vince Cable: Of course, Kraft is now doing quite a lot of global R and D work here. In terms of where it led, the first set of actions related to the takeover panel, where we did encourage the takeover panel—a self-regulating body—to toughen up its approach to takeovers. The expression used is “throwing a bit of sand in the wheel”. There are the put-up-and-shut-up requirements; the requirement that boards are no longer obliged to take the biggest offer if it would lead to a short-term benefit but long-term loss; and greater transparency over the fees of the intermediaries who are making money out of the takeover. All those things came as a direct consequence of that worry about takeovers. There has subsequently been quite a lot of stakeholder consultation around the takeover panel’s activities. The conclusion we have come to, at least for now, is that those changes have made quite a bit of difference—probably more than we had assumed at the time. If there is a new surge of takeovers which have the damaging effect that you and others fear, we can certainly go back to this. There are issues you may want me to discuss about whether we should be giving preference to long-term investors over short-term investors, and so on, which we have not yet done and are difficult. However, we can certainly go back to those if there is another outburst of unhelpful activity.

Q330 Mr Binley: Secretary of State, that is encouraging and I am most grateful to you. Can I, however, just be slightly more specific about the short-termism involved in hedge-fund funding that happened, to a sizeable extent? I think about 27% of the money in the Cadbury takeover was provided by very short-term hedge-fund thinking, and it was a hostile bid. I just wonder whether we can still go back to the possibility of a time limitation on hostile takeovers, and whether there is anything we can do about short-term money, in the light of your need to have more long-term investment.

Vince Cable: My instincts are to go back to it. As the Chairman quoted of me in my party conference speech, that is probably where my instincts are. Let me just set out the reasons why we have not done that, and they are quite compelling. You could perhaps help

me by finding a way past them. The arguments that are put are the following: first, if you stop the short-term investors, you reduce the demand for shares, you drive down the share price and you then make the takeover more attractive; secondly, you stop long-term investors from acquiring shares in order to build up their stake in the company during the takeover period; and thirdly, we do not have an effective system, at the moment, for distinguishing between nominees and original owners. In the UK, we do not have that, so it is not possible to divide the share register in the way that one would ideally like. Moreover, if you tried to, there is a danger of setting up secondary trades in ultimate ownerships—in other words, to defy the rules. Now, I see those as a challenge rather than as a fundamental objection to never doing anything, but these are quite serious problems, and if we are ever going to take that forward, we have got to find a way around those arguments.

Mr Binley: You set us a challenge and I am hopeful the Chairman might accept it.

Q331 Ann McKechin: Good morning, Secretary of State. There is a current argument that there is really no way to establish whether public companies are providing a good purpose or if the market price really reflects the true value. Which of Professor Kay’s recommendations would rebalance this perception, in your view?

Vince Cable: I am not sure if this is quite what you are driving at, but he does raise the old issue about whether mark-to-market pricing is, in fact, seriously distorting, or actually helpful—that is the issue he raises. The problem is we are operating with international and European rules on mark-to-market accounting. One way in which we have anticipated the criticism you rightly made about there often being distorted values is through the pension regulator, which now has an obligation to look at long-term growth. With defined benefit funds, they will be obliged to think beyond the immediate mark-to-market solutions, which could involve them doing very damaging things to companies. Kay does pursue that argument and suggests the way forward.

Q332 Ann McKechin: So you are hopeful that if there is a change by this major set of institutional investors, that would actually also influence the entire market, as a result.

Vince Cable: Yes, it could do.

Q333 Ann McKechin: Which of Kay’s recommendations will change the perception that institutional investors do not act as true owners of businesses? You have mentioned pension investments. There is also this issue about fiduciary duty and you have asked the Law Commission to review it. Perhaps I could just press you a little further. Do you consider that when the Law Commission does eventually report, the Government then actually have to provide the clarity and guidance to make the changes, if they are recommended, in legislation?

Vince Cable: Yes. This is actually a very important stage in the follow-up to the Kay Review, and thank you for picking it up. We set the terms of reference today, where the Law Commission is already actually looking at this, because there is ambiguity about what fiduciary duties really are in different points of the

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investment chain. The answer to your question is that yes, if it does recommend legal change—it may well do—we will go down that route, but we obviously do not want to prejudge what they conclude.

Q334 Ann McKechin: Do you have any anticipated timetable for when it is likely to report back?

Vince Cable: I asked myself and my officials that question. I did not want this to be reporting in 25 years time. The Law Commission does have a *Jarndyce v. Jarndyce* approach to legal cases. We would express the hope—and I have expressed the hope—that it will do this quickly.

Q335 Ann McKechin: By “quickly”, do you mean some time this year?

Vince Cable: I would hope that before the end of this Parliament we will have a very clear answer to the questions we pose.

Q336 Ann McKechin: Should more people in fund management have practical experience of business management? This is an issue that Lord Myners, as you may recall, raised in his evidence, and it has also been raised by others. As few hedge fund managers have practically run a business, their ability to make long-term decisions or to understand them is limited.

Vince Cable: I guess, in an ideal world, that that should happen. We could probably say that for politicians as well, but we do not have many, with one or two exceptions here. I am not sure how you would make that happen, other than to incorporate it into best practice. Given that the investment management chain is now adopting best practice codes, maybe that is a good thing that should be incorporated.

Q337 Ann McKechin: Could that be part of the stewardship code that Kay talked about? Could there be reference to people having more experience?

Vince Cable: Yes, I take your point entirely. Of course, there are big companies and small companies and they have different levels of expertise associated with them.

Q338 Chair: Just before we move on, I am not sure which representative group it was, but certainly one pointed out to the Committee that the parliamentary contributory pension fund has not signed up to the stewardship code. I recognise that is not your specific responsibility—it is, indeed, a collective one here—but I personally feel that is slightly embarrassing, as we need to be exemplars ourselves. Do you see any role for the Department in promoting that?

Vince Cable: I was once a trustee of that fund.

Chair: So you are to blame.

Vince Cable: When I first came in, so I am probably partly to blame.

Chair: I have to say I was not aware of that when I asked that question.

Vince Cable: As we know, Government and Parliament are distinct entities, and we would not want to lean on Parliament to improve its practice. However, you make a very good point and if there are any trustees here, they should take it as their responsibility.

Chair: We will be looking at a way to do so.

Q339 Mike Crockart: I would like to turn to specific recommendations. First of all, on the third recommendation, it says, “An Investors’ Forum should be established to facilitate collective

engagement by investors in UK companies”. To me, that sounds a bit like management speak, and it is unclear exactly what it is driving at and what the investors’ forum should be doing. We know that the Investment Management Association is taking that forward, but have you provided a remit for what that forum should be looking to do? Do you have views on what the features of it should be?

Vince Cable: We do not have a remit and we did not consider that our job. We considered the Department’s job to be actually trying to get the people together to make sure they did it, because we had thought that the Kay Review was sufficiently clear about what that investors’ forum would achieve, and that the bodies should themselves take the responsibility for organising it and should promote it—which they are now doing through the steering body—but, of course, they should not run it, because it should be independent of the trade bodies. It is going to be quite tricky because, on the one hand, we are getting them to talk to each other, and we are getting people to talk about the boundary between investment institutions, but we do not want collusion and we do not want insider trading, which is the worst form of conversation that could take place. The best institutions do have very clear Chinese walls to permit these conversations to happen. To answer your question, no, we do not have a departmental remit telling them what we think they should do; we think Kay gives enough guidance on that.

Q340 Mike Crockart: Do you have any knowledge of when the first investors’ forum will actually be held?

Vince Cable: I do not, but now that this steering group is established, I would hope we are talking about weeks or months, rather than years, but I cannot give you a precise answer.

Q341 Mike Crockart: The ABI, IMA and NAPF issued a press release today which, in fact, I have to say is a mastery of saying very little and using lots of words to do it. Having read it, I am unclear whether what is now being set up, which is a working group, is the investors’ forum, or whether it is a working group to look at what an investors’ forum should be doing.

Vince Cable: I think it is the latter.

Q342 Mike Crockart: Right, okay. So it is to report in the autumn with recommendations as to how collective engagement might be enhanced to make a positive difference. It feels quite amorphous and it is difficult to see what progress is being made in any real time.

Vince Cable: That is, maybe, a fair criticism. I would take it as a criticism of them.

Mike Crockart: Absolutely, but I am raising it with you.

Vince Cable: If the forum has not happened in the autumn, when this steering group reports, I think you would have good grounds for coming to me and saying, “Why aren’t you chivvying these people along? The report’s been out there for a year or so. Why is nothing happening?” That would be perfectly legitimate.

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Q343 Mike Crockart: Do you have views about the specific resources that an investors' forum would require, in terms of funding, particularly?

Vince Cable: We have envisaged that this is something the industry should be doing in its own interests and it should fund it. There has been an issue about levies. The real resource that would be required is serious research, particularly if you are developing metrics and things of that kind. We are organising, at the moment, a competition to establish better metrics for investment managers in the investment chain, but it would be the industry's job to put this on a permanent footing, and it would have to fund it. There is an issue about how they charge their members for it and how transparent that charge is. The simple answer is that we do not see this as the Government's job. It is the industry's job; its own reputation is at stake.

Q344 Mike Crockart: But a watching brief would be kept. Turning to another specific recommendation—we have touched on it a little bit—which is that the Law Commission should be asked to review the legal concept of fiduciary duty. Can I start by asking what you understand by the term “fiduciary duty”?

Vince Cable: It is the duty in law of the people in the investment chain towards their clients. I think that is what we are talking about.

Q345 Mike Crockart: Given the fact that most of our witnesses seem to have a clear view, much the same as yourself, of what fiduciary duty is, why do you think that the Law Commission needs to have a look at redefinition? How do you think that will actually help compliance?

Vince Cable: This goes right to the very beginning and how far they have an obligation to think about long-term value, rather than short-term returns. What does the existing system of investors' responsibilities tell us? Again, I am not a lawyer and I am certainly not a lawyer in this rather recondite field, but I am told that the law is a bit ambiguous and it needs clarification as to where first duties are when there is a conflict of objectives.

Q346 Mike Crockart: Although most of our witnesses seemed to be fairly clear about what it meant, one witness did say that they thought the law prohibits good behaviour, or that there was certainly a perception that law prohibited good behaviour.

Vince Cable: That is exactly the kind of thing that we need to get to the bottom of. When people are saying things like that, which sound a bit strange but are maybe true, we need to get the top lawyers in the country coming to a definitive ruling.

Q347 Mike Crockart: My final question was going to be: what should we expect after the Law Commission has reported? However, I think you have already answered that in saying that you are minded to take forward any recommendations that it comes up with.

Vince Cable: Yes, I would sincerely hope so. It probably requires legislation, but that is obviously a matter for the House.

Q348 Chair: In terms of both the investors' forum and the Law Commission review of fiduciary duty, it would appear that a process is being set up that could significantly delay any action on these issues.

Certainly, in terms of the latter, I have had it to put to me that giving it to the Law Commission is just a way of kicking the issue into the long grass. Have you set a deadline for either—or both—the investors' forum to be set up or a conclusion on the issue of fiduciary duty from the Law Commission?

Vince Cable: We have not set a deadline, but I have specifically asked that they deal with this expeditiously and get a move on, precisely because of the suspicion that I had already heard, which you have expressed very well. We do want some answers quickly. The problem about taking shortcuts on complex, legal questions is that the outcome is then disputed. The whole purpose of going to the Law Commission is that what emerges then becomes a definitive interpretation that we can act on. It is frustrating and, like you, I would much rather we had some quick results with some of these things.

I think there is a prevailing cynicism—sorry, in fact I have actually got something more concrete. The Law Commission will consult this year and report no later than June 2014, so there is a deadline. I am sorry; I misled you.

Chair: Yes. I was going to say I am not sure whether that reinforces your argument or the argument of representatives of the Committee. It does demonstrate that the Law Commission's interpretation of a speedy review is rather different from that of most people in the universe.

Q349 Mr Binley: I note in the Government's written submission to this particular inquiry that you are promoting the revised edition of the stewardship code, which was published in September 2012, which emphasises that stewardship should encompass engagement via investors in company strategy. You will know, Secretary of State, that I, and I think other members of this Committee, are not overly enamoured with voluntary codes, and I would only point you to the pub code in that respect, where prevarication has been the name of the game, almost from the outset. Are you concerned about whether the code is fit for purpose now—and clearly you are not, because you are waiting for what the Law Commission says—and what powers do you have in your own hands to make sure that it is an Act that is brought into effect in good time, and it does not linger on as the pub code has almost ad nauseam, quite frankly?

Vince Cable: The way we are dealing with companies is a mixture of voluntary stewardship codes of practice, on the one hand, and legislation on the other—there is a two-track approach to most of these questions. In the mandatory area, of course, we have the legislation on executive pay, and narrative reporting is coming into effect as well. On the stewardship code itself, we have just had a wholesale revision, which the FRC oversaw—you know the way the system works. Next year, we have asked them to go back to the stewardship code specifically to take into account the Kay recommendations. It is a twin-track approach. There are key areas of corporate behaviour that have to be regulated, and are regulated, but for other areas, where subtle changes are involved, the voluntary approach works well, as it is the best solution and it works.

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Q350 Mr Binley: I accept the last phrase. I wonder if you can give us a little more confidence by telling us the evidence you have to the effect that the voluntary code will work in this respect, because we are perhaps talking about a pretty heavy area of activity dealing with other people's money. One might think that that gives it an extra impetus for action.

Vince Cable: Maybe I should just give you one example of where voluntary behaviour is moving in the right direction, but where you have the ultimate sanction. Maybe I could give you two examples where you have the sanction, ultimately, of a regulatory solution. One of them is the disclosure of votes in companies, where we have progressively had an increase of disclosure—on one measure it is 75%; the TUC has a slightly lower measure. There is clearly a tendency towards disclosure by institutional investors on how they voted on issues like executive pay, so the trend is in the right direction. They know, and we have said, "If you don't do it, we will ultimately legislate," but voluntary behaviour has worked. The other slightly different area is female representation on boards, where we are adopting a stewardship-code approach. We have set objectives and asked them to do it themselves in their own way, and there has been a significant change over a two-year period.

Chair: We are looking at that issue in a separate inquiry.

Vince Cable: Yes, I did not want to get into the issue. I was just using these examples for Mr Binley about how a voluntary approach can achieve results.

Q351 Mr Binley: Can I ask you about time frames? You have responded, pleasingly, very quickly with regards to the prevarication with the pub code, and we welcome that enormously. I wonder what time frame you are thinking about giving a voluntary code being set up in this respect before you do move to your heavier shot across the bows.

Vince Cable: It obviously depends on the feedback. We knew there was a problem with the pubs because of the howls of pain from a lot of publicans. If we get a very strong sense from companies that, despite all this nice talk, nothing much is changing and they are being short-changed by the equity investor community, we can do stronger things. It depends on the feedback, obviously.

Q352 Mr Binley: So the Law Commission data are pretty important in terms of your judgment in this respect.

Vince Cable: On the fiduciary duty issue, yes.

Q353 Mr Binley: Also, can we link the same sort of time frame to the code?

Vince Cable: Yes, the stewardship code is being revisited next year anyway.

Mr Binley: That is what I thought.

Vince Cable: By the FRC. It has already committed itself to doing that.

Q354 Chair: Before we leave this issue, I do recall us having a disagreement on this at a previous session when you were talking about salaries. There does seem to be conflicting evidence on the level of, shall we say, transparency and adherence to the stewardship code, and you yourself pointed to different evidence from different bodies. My understanding is that, first of all, not enough companies sign up to the

stewardship code. Secondly, there are those that do adopt a tick-box approach, which does really reveal the full extent of their involvement or lack of involvement. What evidence will you use as an evidence base for determining whether you need to go in harder on this?

Vince Cable: I would turn it back to you, in a way. I have not heard the stewardship code being discussed in quite such negative terms, but if your Committee—

Chair: I do not think it is the stewardship code that is; it is the adherence to it and transparency.

Vince Cable: If your hearings—and this is what you are doing—do elicit quite a lot of evidence that this approach is failing, I would feel obliged to respond to it, as I did when you similarly did valuable work on the pubs.

Chair: That is a very welcome comment, Minister. We may well look at that. Thank you.

Q355 Mr Binley: I think I know the answer, but do institutional investors dedicate enough resources to corporate governance and stewardship, in your opinion?

Vince Cable: I would like to see more, but I cannot give a very informed response.

Q356 Mr Binley: It does lie at the heart of what you are trying to do, does it not? I wondered whether you have got any evidence, because Aviva Investors is suggesting a simple way of resourcing stewardship: use equity commission towards what it calls a long-term investment on research, voting advice and stewardship work. Is that how you thought this thing should proceed?

Vince Cable: I said, in response to Mike Crookart's question, that clearly there does need to be proper research and they do need to have good metrics that are trusted and credible. That does involve a certain amount of investment and the obvious way for the industry to invest would be to make a contribution from its own coffers, and those would then have to be transparent so that investors are aware of them.

Q357 Mr Binley: Again, time frame is important. I wonder how quickly you then feel that could be implemented.

Vince Cable: Again, it would be a bit invidious if I just plucked a date out of the calendar. We are hoping that by the summer of 2014, when the Government conducts its own review of the effectiveness of the Kay Review, of which this is one, we will then be able to see tangible progress. That is the kind of timeline we are working to.

Mr Binley: So, we revisit this in a year's time or thereabouts.

Vince Cable: In about 15 to 18 months.

Q358 Paul Blomfield: Secretary of State, I wonder if I can move to a different issue: the financial transaction tax. We have heard from a number of the witnesses, including Professor Kay and Lord Myners, that there is a positive case for an FTT. Putting aside the specifics of proposals that might be on the table at the moment in Europe, on which you have expressed your views, and also putting aside the revenue issues, do you think that there is a case for a financial transaction tax to discourage short-termism?

Vince Cable: Yes, I think there is a case, and I am, in some ways, quite disposed to it. I originally worked

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on Tobin tax concepts 20 or 30 years ago, long before I came into this place. The problem, all along, has been implementing it in a way where you have very rapid electronic transactions where cross-border transactions are very difficult to trace. I saw some of the figures this morning coming out of the European Union on its first experience of this. Countries like Hungary, France and elsewhere were getting in a fifth or a quarter of the revenue that they thought they would get, because it is so very, very difficult to pin down these transactions and tax them in a sensible way. I have no objection to—well, I would put it more positively: I think there is a case, if you are trying to change behaviour, for using a market instrument of that kind to make that happen.

Q359 Paul Blomfield: Is the rapid nature of the electronic transactions not part of the case for the tax?

Vince Cable: It could well be. The problem that Tobin was originally trying to address was transactions in foreign exchange markets. We have now moved on to a different world where that is no longer an issue, but you could argue that for very rapid transactions, which yield very little value—I think Lord Turner came before your Committee and may have made that case a couple of years ago—there would be an argument for using tax in that way. The reason why the British Government have been pretty negative about it is mainly on grounds of practicality. The other reason we have been sceptical about it is, of course, most of the revenue would be generated in the UK and, under the European Union's proposal, would be repatriated to Brussels which, understandably, we are not too happy about.

Q360 Paul Blomfield: Putting aside the specifics, given there is general warmth to the idea, we have also heard that it was an area in which the review feared to tread. Are you concerned that the review that you commissioned felt that it was unable to recommend freely in this area?

Vince Cable: In relation to that tax?

Paul Blomfield: Yes.

Vince Cable: They certainly were not forbidden from doing it, or discouraged from doing it. John Kay is a very good economist and has written extensively about it, and he probably realised that the analysis had been pushed about as far as it could usefully go. I suspect that that was why it did not feature more prominently.

Q361 Paul Blomfield: Did you have a specific conversation with him at any time about it?

Vince Cable: I seem to remember it was on the agenda when we had our report-back sessions, and we did exchange views about whether the tax system could be used to change behaviour. The transaction tax is one, but there have also been arguments, as you know, about capital gains tax, which operated under a different regime when your party was in government. That is another way of using the tax system. There was some discussion of that, but I think he felt it was not very productive.

Q362 Paul Blomfield: On a related issue, the Chancellor, when he was making his Budget statement in relation to stamp duty, said that in parts of Europe they are introducing a financial transaction tax, but

here in Britain we are getting rid of one. Did he consult you about his decision on stamp duty?

Vince Cable: That combination of things was not put together. They are very different.

Paul Blomfield: It was interesting that he linked them in that way.

Vince Cable: We are actually increasing stamp duty in the UK on high-value properties, as you know, so there are certain kinds of big, lumpy transactions where we are using stamp duty to deal with, frankly, rampant tax avoidance that is happening at the upper end of the property market. We are therefore using stamp duty in certain cases. The reason why it has been waived in respect of AIM is to achieve a particular set of policy objectives, which is to reduce the costs of medium-sized companies coming to the market. There is an enormous difference between the way the stamp duty would operate on an AIM equity deal, which is one big payment for one lumpy deal, as opposed to trying to tax a thousand electronic transactions in a minute or however the system works.

Q363 Paul Blomfield: Perhaps I could move on to a different area: mergers and acquisitions. I know a number of colleagues will also want to come in on this one too. Perhaps to start off, how do you see the nature of mergers and acquisitions in a post-Kay world?

Vince Cable: At the moment it is fairly dormant; there is not a great deal of activity taking place. There are large cash piles around that you would have thought, in normal circumstances, companies might use for aggressive acquisitions. My general view about this, which I have expressed to your Committee before, is to be a bit sceptical of the value of takeover activity. There is a lot of research that tends to show that, probably on balance, it reduces shareholder value, quite apart from any social consequences. However, there is counter-evidence. There was a big report by the Cass business school a year ago, which tended to show the opposite. I am sceptical about the value of takeover activity, but recognise that in a capitalist system, you do need to have it, because if companies are underperforming and their shareholders are being poorly awarded for bad performance, there has to be a mechanism in the market to correct that.

Q364 Paul Blomfield: Do you think that things will change specifically as a result of Kay's recommendations, if implemented?

Vince Cable: Not a great deal. If we are looking for change, we would have to look to the takeover panel and the existing rules, and whether they need to be developed further, and indeed the more radical solutions, which have often been put about public interest tests, which we have not followed through. However, if one was really concerned about damage in this area, that would be the way to do it. There is nothing in the Kay Review that will radically change the mergers-and-takeover landscape.

Q365 Paul Blomfield: Can I ask you specifically about shareholder rights? Very specifically, at the time of takeover, do you think that short-term shareholders should continue to have the same voting rights as those with a long-term interest in companies?

Vince Cable: I gave quite a long answer to the Chair or Mr Binley about that before. We have certainly

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looked very carefully at this because of the reasonably well-grounded fear that hedge funds and other short-term investors can drive the wrong kind of merger. We looked at that very carefully but, as I said, attempts to restrict it by making an arbitrary distinction—say between a six-month investor and a six-month-plus, or a year and a year-plus—would probably have all kinds of unintended consequences and would be very difficult to pin down because of the issue of nominee shareholders. I agree with you that it is a serious question, and I frequently engage serious people who try to make that case, and I have quite a lot of sympathy for them.

Q366 Chair: I believe I am right in saying that one of our previous witnesses claimed that there had been no benefit from any hostile takeover in the UK over the last few years. Is there any authoritative research that the Government have done to assess whether this assertion is correct or not?

Vince Cable: I think I am correct in saying that the Cass business study was actually prompted by our Department, but I cannot remember whether we funded it or not, but we certainly encouraged it. It did not actually reinforce that conclusion—I might say “unfortunately”, but it did not.

Q367 Paul Blomfield: Specifically on section 172 of the Companies Act, do you think shareholders’ interests are best protected through it, and is there a case for changing the Act to integrate Kay’s principles?

Vince Cable: I am hazily aware of this Act and what it says, but that would be covered by this fiduciary duty reference, would it not? We are doing that partly to establish whether the law is clear enough in respect of shareholder rights and the duties of managers. That links to the issue of fiduciary duty, which I have tried to answer your questions on already.

Q368 Mr Walker: Secretary of State, we have taken a lot of evidence and you yourself have said you are sceptical about the value of M and A. We have taken a lot of evidence and Kay himself talked about the transactional nature of investment nowadays, and the fact that it has gone too far down the transactional route. Do you feel that there are enough recommendations in Kay and enough detail in the Government response actually to change that culture and move away from a transactional focus that drives M and A and makes that an inevitable part of investment?

Vince Cable: As we have said before, the Kay Review did not really go very far into that territory and it may have been useful if we had got a stronger steer on it. It did not actually say a great deal about it. To amplify what I said before, there is a counter-view. I think the CBI, for example, argues that there are not enough mergers and acquisitions among medium-sized companies, because it thinks that would be a way of galvanising that sector of the economy. The premise there was that that kind of activity could be beneficial. I stated my own view, which was to be a bit sceptical about M and A activity and its wider values. There is a strong view in business—and I think genuinely, not just by self-interested people—that it has an important role to play.

Q369 Mr Walker: One area that Kay talked about, and that you mentioned earlier, was this idea of a public interest test for overseas takeovers. It is widely touted that the UK is probably more open than any other jurisdiction in the world to overseas takeovers. We have mentioned the issue of Cadbury, but I could list a whole slew of other takeovers over the years where UK companies have been taken over. Is that an area where you personally feel there is more scope for Government to get involved?

Vince Cable: No, I do not, and I have argued this with your Committee before. As a Government, we have rejected the Heseltine recommendation on foreign takeovers, and personally I think we should reject it. We should not be distinguishing between domestic and foreign ownership. It is not helpful, and some of our best companies are owned by “foreigners”—whatever that means these days. If you talk about Jaguar, Land Rover or Nissan, these are superb companies. They are not just good companies; they are very committed to Britain, and they invest heavily in R and D here. They see a future for this country. They see themselves as good corporate British citizens, whereas there are plenty of, essentially, British companies that have no attachment here at all. Distinguishing on the nationality of the owner is not useful and, on the contrary, the fact that Britain has a very good reputation for not being nationalistic stands us in very good stead when it comes to attracting good investors here.

Q370 Mr Walker: Just in terms of investment, a lot of the Kay Review focuses on the investors and financial intermediaries, so far as they sit on the buy side of the equation. There are very few recommendations or Government responses that relate to the sell side, and the culture in terms of the banks and institutions that are driving a lot of this process. I put it to you that, actually, the biggest change in culture over the last 20 years, which has moved us towards a transactional culture, has actually taken place in the banks, in the brokers and in the organisations that are selling these deals to businesses, management and their investors, rather than on the buy side. Is there not perhaps a need for the Government to be looking at that area, and is there a problem with the fact that that falls under the remit of the Treasury, rather than BIS, and therefore your Department is not able to set the agenda in that sense?

Vince Cable: I agree with your general point that the culture of financial transactions is being driven by the banking system, probably rather more than the things we are discussing here. We are not, as a Department, excluded from that. I have been very heavily involved in the arguments about banking reform and Vickers and electrification or whatever. In terms of the conduct of banking, Andrew Tyrie’s commission are the people looking at that. They seem to be coming out with some very sensible approaches and it is getting into exactly the question you described: they are looking at the culture of banking and the damaging effect that has had.

I would make one very specific point that does not relate to Kay, but is highly relevant, which is that what has caused so much damage with the SME community is not just the post-crisis problem of lack of capital;

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it is the fact that these institutions stripped out their relationship banking 10 or 15 years ago. They replaced their relationship managers with insurance salesmen; it was absolutely hopeless. It has affected the culture in a very damaging way. This, in a way, takes us back to the earlier part of the discussion about encouraging equity as opposed to debt. This is one way of avoiding the damaging influence of money-lending institutions, in that you have a stronger equity base for capital.

Q371 Mr Walker: I completely agree. I put it to you that we talk a lot about the incentives for management and for investors. The incentives for the sell side and for the bankers are going to be a crucial part of that and perhaps that is something for Andrew Tyrie's commission to look at. It is generally agreed that to address this area—particularly the stewardship issue—it is going to take a lot of cross-departmental work. Do you feel that, around the Cabinet table, there is a consensus on the direction of travel here?

Vince Cable: I think so—not narrowly on Kay, but on things like corporate governance as it related to executive pay we could have easily diverged. If you go back 15 months ago, there was quite a vigorous debate inside Government and with outside institutions about where we should go on all that, but we finished up in the same place, hence the legislation that you in Parliament have subsequently dealt with. The one issue that might have caused some disagreement was about quarterly reporting, but we are all agreed that that is unhelpful—the mandatory requirement. The problem of shifting it is not that there is difference within the Government; it is that we have got to get the European Union to go back on this, and we think that we are fairly close to getting it.

Q372 Mr Binley: Secretary of State, we have had discussions, as I have already mentioned, about the Cadbury takeover, but is not one of the lessons not to distinguish between home-based and foreign-based ownership, but to distinguish between hostile and non-hostile attacks, as it were, for mergers and takeovers? There is no doubt that hostile attacks have much more opportunity to be damaging because of the very fact that they are hostile to start with. I just wonder whether you could not make that distinguishing comment and whether, if we come back with some answers to your challenge, that might figure in your thinking.

Vince Cable: I am not sure how you distinguish with any clarity between hostile and non-hostile. One of the issues that arose in the Cadbury takeover, as you remember, was that the people who were being “attacked” were perfectly happy to sell their shares to the hedge funds, otherwise how did the hedge funds get the shares in the first place? The idea that this is a crime with victims does not quite fit the way that markets operate.

Q373 Mr Binley: With respect, do we not live in a world now, with arbitrage and so on, where you do not know who you sell your shares to? Is that not one of the problems?

Vince Cable: That is, I am sure, one of the problems. When I described some of the changes in the takeover panel's own principles, one of the things they do now do, in addition to the put-up-or-shut-up provisions and

the greater transparency, is to require the acquirer to state their intentions for the company in a much more explicit way, so you can identify—or the shareholders of the company that has been attacked, as it were, can identify—the objectives of the people who are trying to take them over. I agree that that does not solve the problem, necessarily, but it make the whole process a bit more transparent.

Q374 Paul Blomfield: I just wanted to pursue that point a little bit more. In answer to Robin, you said it was not helpful to distinguish between home-based and foreign-based ownership. You cited some very good examples of foreign-based owners who very much take a very positive role in the UK economy. Equally, I could cite to you, from the Sheffield steel industry, examples where foreign-based owners, as times get tough, retrench. When they retrench, they tend to retrench to the country of ownership for production. Do you not see any merit in the Government supporting UK-based ownership?

Vince Cable: I am not sure that what you say is true, actually. The Brinsworth Strip Mill is owned by Tata, is it not? It has shown at least as much commitment—

Q375 Paul Blomfield: I am acknowledging that there are examples of good foreign ownership but, equally, there are examples where that does not work, are there not?

Vince Cable: I just do not think it is true that overseas companies necessarily retreat to base in conditions of difficulty. If there is some hard evidence on that clearly that is significant, but I have never seen any, to be quite honest.

Q376 Paul Blomfield: So you do not think there is merit in encouraging UK ownership.

Vince Cable: I do want to encourage British entrepreneurs; that is a different point. We do want to encourage an entrepreneurial culture among our own people. There are problems with British entrepreneurs who grow to a certain size and then sell up. There is a genuine problem there, for which I do not think any of us totally understand the reasons. We do not produce our own Facebooks here; they get to a certain point and then sell out. It may well be that, in that particular industry, American investors will take them over, and that is a bit worrying, but not because the people who have taken them over are Americans, but because our own entrepreneurs do not have the incentive or the motive to stay the course, as it were. You are right to say that we need indigenous entrepreneurs and to encourage them, but I do not want to turn this into an anti-foreign investor thing.

Q377 Mr Walker: You are going to be publishing a progress report in the summer of 2014. What do you think is the minimum that should have happened by then?

Vince Cable: I would have thought that the minimum is that the investors' forum, which is at the heart of Kay's recommendations, would be up and running and functioning, and we would be able to see a discernible impact, and that the various statements of good conduct that have been issued by the trade bodies will be in place and will have been visibly acted upon. I would hope that, at roughly the same time, we would have a clear conclusion from the Law Commission, so we would have various pieces to put together a

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year before the end of the Parliament to be able to say, "Yes, things are moving".

Q378 Mr Walker: The majority of the Kay recommendations are quite vague on what the outcomes are going to be. Are there any specific targets that you would want to see hit, or any specific measures through which we, as a Committee, can hold the industry and the Government to account?

Vince Cable: You keep saying the recommendations are a bit vague. They are general and they do rely on trust and voluntary activities—this goes back to the very beginning. I think a lot of people were a bit surprised that he adopted that approach, but I do not quarrel with it, providing it does result in some change. As I say, we are setting up a mechanism to change it. I would be very disappointed if, within the next year or so, we have not, for example, changed the rules around quarterly reporting, because that is a very concrete thing that he has identified. It is in the power of Governments—not just ours—and it is a very tangible manifestation of a short-term-driven business culture.

Q379 Mr Walker: Who is responsible for taking that forward?

Vince Cable: It is our job to take that forward with European Ministers.

Q380 Chair: Just to conclude, Minister, you have said that, basically, these proposals rely, to a great degree, on trust and voluntary activity. Now, given the fact that this is an industry where trust and voluntary action in the public good has not exactly been very obvious, what would you do if you were satisfied, within a year or so, that this is not the right way forward?

Vince Cable: I am not sure I accept your point. There has been a collapse of trust in the banking system, for sure, after what has happened. I do not think that is true of the other institutional investors. After all, most of us still trust our savings to them. We do not try to bypass pension funds, even where we have the choice, and we do not try to bypass insurance companies; we still use them. We would not do it if there had been a collapse of confidence. The main task now is just to make sure that they do operate better in the interests of their shareholders and the original investors in them. That is what we are about. I do not totally share the premise of your question.

Q381 Chair: I find that rather odd given your comments that I read at the beginning of this session. You were not referring to just the banks then; you were talking about the industry in general.

Vince Cable: There are a lot of rogues. There is a lot of bad practice. There are a lot of bad companies, and in some sectors, we have seen this rampantly so. Banking is one and media, dare I suggest, may be another, and action is being taken to try to deal with those abuses. I did use strong language because there

are some serious abuses, but that does not mean that the whole system of private enterprise, in general, and of institutional investors, as another, is corrupt, rotten and falling apart, because it is not. There are some bad examples and we need to deal with them.

Q382 Chair: It is more than just bad practice though, is it not? There is an underlying belief that the financial services industry does not think long term; it only thinks short term. I would have assumed that some of your comments previously were designed to remedy that.

Vince Cable: It does not think only short term, but there is a short-term bias. Pension funds, by their very nature, think long term—they have to. The underlying problem we are trying to deal with is that there are savers who want to save for the long term. There are pension funds trying to invest for the long term and there are companies out there that want to borrow or get equity investment for the long term to make investments. Somewhere in the chain, there are short-term incentives, which is essentially what the Kay Review is all about—that that collective interest we all have in good long-term investments is being twisted or diluted by institutions that do not work properly. It is somewhere in this system of incentives that the various investment managers have. That was his major conclusion and it is what we are trying to address.

Q383 Chair: You have put your finger on the crucial problem. It is the managers of our investment who have a financial motivation for working and thinking short term. I come back to the point I made: if, after a year or so of examination, it is obvious that this is not changing, what will you do then?

Vince Cable: I do not have any problem with adopting tough regulatory solutions when voluntary methods have failed and we have demonstrated that in one or two areas, with executive pay being the most obvious one. It will be the same with takeovers, if it proves to be necessary. My approach to all these things—women on boards, and a lot of other things—is to try the voluntary approach and try to build up trust with the practitioners. If it fails, we can adopt more aggressive solutions, but let us try the voluntary approach first.

Q384 Chair: Thank you, Minister. I expect that we will come back to this some time before the end of this Parliament. We recognise that, certainly in terms of the pub companies, you, shall we say, were open-minded enough to accept our criticism and do something about it, so if we feel the need to take further action, we hope that you will be open-minded in the future to do something about it in the future as well.

Vince Cable: Definitely.

Chair: Thank you very much and we appreciate your contribution.

Written evidence

Written evidence submitted by the Government

1. In June 2011, the Secretary of State for Business commissioned Professor John Kay to undertake an independent review to examine investment in UK equity markets and its impact on the long-term performance and governance of UK quoted companies. This followed the Department's earlier call for evidence "A Long-Term Focus for Corporate Britain", launched in October 2010, which explored issues of economic short-termism in the UK. The responses to that call for evidence found that there was evidence of short-termism in UK equity markets and of some agency problems in the investment chain.

2. The Kay Review's principal focus was to ask how well equity markets are achieving their core purposes: to enhance the performance of UK companies (by facilitating investment and enabling effective governance and decision making in support of long-term profitability and growth); and to enable investors to benefit from this corporate activity in the form of returns from equity investment.

3. The Kay Report seeks to shift the culture of UK equity markets to ensure they support long-term investment, constructive relationships between companies and their investors, and sustainable value creation by British companies. It has been widely welcomed by business and the investment industry.

4. The Government published its response to the Kay Report in November 2012, welcoming the report, accepting its conclusions and setting out next steps for Government and regulators, and expectations of market participants. The response:

- endorsed 10 principles for equity markets to which market practitioners, Government and regulatory authorities should have regard, and the report's directions for market participants which follow from these principles;
- committed to working with the relevant regulatory authorities to explore further the Kay Report's directions for regulatory policy—to identify to what extent these directions are practical, what changes in the law or in regulation might be therefore be appropriate, and how these can best be delivered; and
- set out a number of steps the Government is already taking to deliver on the Kay Report's detailed recommendations, including:
 - completing reform of corporate narrative reporting to be higher quality, simpler, more relevant to users and more focussed on forward looking strategy;
 - pursuing reforms to the EU Transparency Directive which will remove mandatory quarterly reporting; and
 - promoting the revised edition of the Stewardship code (published in September 2012) which emphasises that stewardship should encompass engagement by investors on company strategy.

5. Many of the report's recommendations are for market participants, in particular companies and institutional investors. The Government response makes clear that the necessary changes in culture cannot simply be achieved through regulation, but rather through the development of good practice in the investment chain. The Government is therefore promoting Professor Kay's Good Practice Statements for company directors, asset managers and asset holders, as the starting point for industry-led standards of good practice.

6. The Kay Report's recommendations, and the Good Practice Statements, aim to deliver, among other things:

- more collective action by institutional shareholders, including via the establishment of an investors' forum,
- better disclosure of costs in the investment chain, transparency and fairness around the lending of securities,
- better alignment between pay and long-term performance for company directors and asset managers, and
- a greater focus on stewardship and engagement to create sustainable economic value in public companies—supported by trust-based relationships and alignment of interests through the investment chain.

7. The Government is now driving forward these recommendations, in particular by:

- challenging business and the investment industry bodies to respond to Professor Kay's Good Practice Statements for company directors, asset managers and asset holders, and give clear direction to their members that will promote the behaviour needed to restore trust and confidence in the investment chain;
- emphasising the principle that all investment intermediaries should act in good faith; in the best long-term interest of their clients or beneficiaries and in line with generally prevailing standards of decent behaviour, and that these obligations should not be contractually overridden;

- asking the FSA to ensure that their regulatory framework supports this principle and pursuing changes to regulation at EU level if this is required; and
- asking the Law Commission to review the legal obligations on investment intermediaries so that investors are clear that they cannot simply assume maximising short-term returns will meet their obligations to their clients.

8. The Government's commitment to take forward the recommendations of the Kay Report is part of a wider commitment to achieving sustainable, long-term economic growth. In particular:

- The Government's Industrial Strategy, launched in September 2012, set out a clear and ambitious vision for a long-term, strategic partnership between Government and industry, focusing on issues like access to finance, skills, innovation and government procurement, in specific sectors in which the UK has a competitive advantage, to ensure businesses have confidence to take long-term decisions.
- The Government has also taken steps to ensure that the new Competition and Markets Authority (CMA) takes an appropriately long-term view. It will have a duty to promote competition for the benefit of consumers—with the objective of supporting long-term growth built into its performance framework.

9. The Government response commits the Government to publish an update, in summer 2014, setting out what further progress has been achieved by government and others, to consider Professor Kay's directions for regulatory policy and to deliver his specific recommendations.

10. The Kay Report does not provide an exhaustive list of detailed reforms but rather provides a framework for further work to ensure investment in equity markets supports UK companies to deliver sustainable long-term economic growth. This will require a sustained commitment to reform from government, regulators and market participants. The Government therefore welcomes the Committee's inquiry as an important contribution to the debate about how to take forward Professor Kay's directions for market practice and regulatory policy, and how to develop and embed good practice throughout the investment chain.

24 January 2013

Written evidence submitted by Philip Goldenberg

1. INTRODUCTION

1.1 I am a solicitor specialising in Company Law, Corporate Finance and Corporate Governance. I was the Legal Adviser to the Royal Society of Arts' TOMORROW'S COMPANY Inquiry in the mid 1990s, and then advised the Government's Company Law Review on the topic of Directors, Shareholders and Stakeholders—I was responsible for the concept of "enlightened shareholder value" referred to in para 3.1 of the Kay Interim Report.

1.2 My general thoughts on this concept were fully set out in a Lecture I delivered to The Institute for Advanced Legal Studies in 1998.

1.3 I wish to comment on a particular topic in the Kay Report discussed at para 3.24 of the BIS Response.

2. SUBSTANCE

2.1 In that para 3.24, the BIS rightly point out that, as a consequence of the related explicit provisions of the 2006 Companies Act as regards directors' duties, directors of an offeree company may lawfully recommend to shareholders that they reject a bid at a premium to the pre-bid share price if they believe that the transaction will destroy value in the longer term or that the offer price does not reflect the fundamental value of the company.

2.2 Sadly, however, this approach is not followed in practice. Take-overs of listed companies are regulated by the Takeover Panel—effectively a cartel of the investment banks with no statutory or regulatory framework (it must be the only regulatory body which is recognised in, but wholly unaccountable under, statute law). And, as with all self-regulation, it favours the "self".

2.3 The Panel's City Code imposes a specific duty on offeree company directors to advise shareholders whether or not an offer price is fair and reasonable. But it does NOT, other than in the weakest generalities, qualify this by a statement of the law as regards directors' duties and set out by the BIS in para 3.24 of their Response.

2.4 As a consequence, City practice is to disregard these duties. The near-unanimous advice by investment bankers to directors of offeree companies is to focus solely and exclusively on price. This happened in the Kraft/Cadbury takeover, and I accordingly also attach for convenience the article on the Cadbury takeover which Mark Goyder (the Founder Director of the Centre for Tomorrow's Company) and I wrote for the Wall Street Journal—please see in particular the penultimate para under "Not Price Alone". Indeed, there was also an earlier case in which Greg Dyke wished to reject the BskyB bid for Manchester United (of which he was

then a Director) because he thought it incestuous for a football club to be owned by a broadcaster, but was overwhelmed by the erroneous advice by Manchester United's investment bankers (who may well have had their fee in mind).

3. RECOMMENDATION

The Committee is invited, in its Report, to recommend strongly that the Government require the Takeover Panel to make the legal position set out by the BIS in para 3.24 of its Response clear beyond peradventure by inserting an appropriate bold textbox in the City Code.

16 January 2013

Written evidence submitted by Standard Chartered Bank

1. We are pleased to submit our response to the Business, Innovation and Skills Committee call for evidence entitled The Kay Review of UK Equity Markets and Long-Term Decision Making. This submission is focused on Kay Review recommendations 3, 5, 15 and 17 as this where we believe we can add most value.

2. By way of background, Standard Chartered is a leading international bank, listed on the London and Hong Kong stock exchanges and is also listed in India (through the issue of Indian Depository Receipts). It has operated for over 150 years in some of the world's most dynamic markets and earns around 90% of its income and profits in Asia, Africa and the Middle East.

EXECUTIVE SUMMARY

3. As a major international bank with dual primary listings, it is our duty to deliver long term value to our shareholders. Standard Chartered's brand promise is "Here for good" which is a long term promise to our clients, customers and shareholders. As a well functioning board we will always strive to focus on the long term growth of the company while being mindful of the near term return factors and will seek to achieve right balance.

4. We believe that our investors have a good understanding of our strategy and long term focus. This is achieved by the significant commitment Standard Chartered demonstrates in engaging with our investors. We engage with our investors frequently, through forums such as the annual Chairman's governance dinner, analyst trips in various jurisdictions, twice yearly results presentations, and multiple meeting with our investors (further details are provided in Appendix 1 (section 3). We have a strong Investor Relations team of 10 who exist solely to communicate and build relationships with investors. We believe the Annual General Meeting provides a good forum for challenge and encourage shareholder attendance and engagement. Therefore any new rules regarding Investor Forums would need to be carefully constructed to ensure that it is complementary to the existing and highly successful Investor Relations engagement. It would not be feasible for all shareholders to be represented on this Forum. Different types of shareholders have different needs and therefore careful thought would need to be given into how membership is defined and controlled while adhering to the principle that all shareholders (within the Forum or not) should have the same access to company information and share the same rights.

5. Director's remuneration is a key topic and Standard Chartered has actively contributed to various consultations during 2012. Much has been achieved within the past few years with many financial services companies having implemented sensible levels of deferral in their remuneration policies. We understand the sentiment of what the Kay Review is intending but need to understand the unintended consequences. Please see Appendix 1 (section 5) for further details.

6. We agree that it is desirable for individual investors to hold shares directly on an electronic register. To achieve this, it is important to ensure that the chosen model for dematerialisation preserves the advantages of the current UK model. This includes direct ownership rights, transparency for issuers in relation to who owns their shares, the choice for shareholders regarding ownership arrangements (via an intermediary or directly on the register) and a continued ability for retail shareholders to trade on a "real-time" basis.

7. We hope that you find our response useful in your deliberations and would welcome having a continued dialogue in relation to this. In the meantime, please do not hesitate to contact me if there is any additional information you require.

Annemarie Durbin
Group Company Secretary

25 January 2013

APPENDIX 1

RESPONSES TO CALL FOR EVIDENCE

(3) An investors' forum should be established to facilitate collective engagement by investors in UK companies

3.1 Standard Chartered PLC (the "Company") proactively engages in ongoing dialogue with shareholders and we find that, in general, shareholders are very receptive to this approach. Dialogue occurs both informally and in scheduled forums as well as in relation to major corporate actions such as the 2009 appointment of our current Chairman, the 2010 listing in India and the 2010 rights issue. We maintain a dynamic shareholder engagement plan in relation to our investors. Senior management typically meet individually with our top 25 investors annually. On a biennial basis, we organise a trip to two or three core markets in which we operate. During these visits investors have an opportunity to meet local management and get a detailed understanding of how the Company operates the business on the ground. This is particularly important given that a large portion of our register is represented by UK or US investors who do not normally have the opportunity to see the Company operating on a day to day basis, and the fact that over 90% of our revenue and profits are generated outside the UK in our key markets of Asia, Africa and the Middle East. We are in regular contact with our investors at conferences, on roadshows, in one-to-one and group meetings or dinners, on reverse roadshows and we regularly respond to investor requests for information. We have a strong Investor Relations team of 10 who exist solely to communicate and build relationships with investors and we periodically conduct an investor perception study to gauge investors' views on Standard Chartered. In 2012 the Investor Relations team hosted a series of presentations focusing on our Asia businesses, Consumer Banking, Wholesale Banking and Group perspectives in China as part of the biennial Investor Trip last November. The event spanned over three days with presentations from senior management covering the scale of business opportunities in our key footprint markets, our progress so far and our plans for the future. Materials from the event are readily available on the IR website for the broader investment community.

3.2 We believe strongly that it is important to engage our shareholders in relation to our corporate governance practices as well as in relation to the investment proposition we offer. In addition to the investor meetings described above where we often talk through governance issues, annually the Chairman hosts a Governance dinner where investors are invited to join an open dialogue on our governance and management structure. The Chairman, the Chair of the Remuneration Committee, and the Group Company Secretary also meet individually with shareholder representative bodies (such as the ABI) as well as individual shareholders to discuss key governance issues. Furthermore, we participate in a broad range of industry conferences and other investor events to ensure all investors seeking access to the Company have plenty of opportunities to engage with us. The Chairman, Group Chief Executive, Group Finance Director and other members of the senior management team are regularly present at these investor events.

3.3 Standard Chartered's shareholder base consists of 28,000 shareholders on the UK register, 32,000 on the Indian register and 3,000 on the Hong Kong register. A large portion of these shareholders are small institutional and retail shareholders. We therefore believe strongly that minority shareholders should have access to information on the Group and be able to fully exercise their shareholder rights. The AGM has historically been the main forum for retail shareholders to meet the Directors of the Company, probe them on any issues and ask questions. Standard Chartered has always believed that the AGM is a key event and believes companies should continue to make it accessible to retail shareholders. Due to the international nature of our register we also offer an audio webcast of the AGM which can be accessed by all shareholders. Questions can be sent into the Company through a dedicated AGM email if shareholders are unable to attend and ask questions in person. Our Directors take shareholder engagement seriously which is evidenced by the fact that they ensure that they are available to "mingle" with shareholders after the AGM during refreshments. We have received feedback from shareholders that they really appreciate this gesture and time spent with Directors.

3.4 We therefore believe that any new rules regarding Investor Forum membership, meetings, engagement, communication, reporting and rights would need to be carefully constructed to ensure that it is complementary to existing investor communication methods and does not replace the existing and highly successful Investor Relations activity. It would not be feasible for all shareholders to be represented on this Forum. Different types of shareholders have different needs and therefore careful thought would need to be given into how membership is defined and controlled while adhering to the principle that all shareholders (within the Forum or not) should have the same access to company information and share the same rights.

(5) Companies should consult their major long-term investors over major board appointments

5.1 Standard Chartered does consult its major shareholders regarding major board appointments and believes that this practice represents good governance. One example of this was the 2006 appointment of Lord Davies as the chairman of Standard Chartered. Lord Davies had been an employee of the group for 15 years and held the role of group chief executive for the five years prior to his appointment as chairman. This appointment did not comply with the UK Code "comply or explain" principle that a CEO should not move into a chairman role for the same company.

However, we engaged with our institutional shareholders to understand their perspectives and to explain why we believed that this appointment was, given all the circumstances, in shareholders' best interests. It was

hugely beneficial to have stability of leadership between Lord Davies and Peter Sands (who moved to the group chief executive role) throughout the extreme turmoil in the banking sector during 2007 and 2008. Responding to institutional investor feedback, we did appoint a new independent deputy chairman at this time. This decision has also proven to be in shareholders' long term interests as it enabled the board to continue to perform effectively in 2009, despite Lord Davies stepping down to take a UK Government appointment. Looking back, this situation was a particularly good example of how "comply or explain" increases focus on the rationale and mitigation of corporate governance concerns; whereas a more arbitrary rule based system could result in company actions that do not benefit shareholders.

(15) Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business

15.1 Arguably the aims of Kay Review can and are already being achieved by sensible levels of deferral which can now be seen in many financial services companies. Many organisations already have shareholding guidelines in place. Deloitte's September 2012 remuneration study showed that most FTSE100 CEOs held 5x base salary in shares. Whilst understanding the sentiment expressed by the Kay Review, we suggest that care needs to be taken to avoid unintended consequences. For example, making executives retain shares could in effect encourage the wrong behaviours like incentivising them to leave the organisation to realise value from their locked in holdings. Alternatively executives nearing retirement could be tempted to take actions designed to drive up the share price in the short term.

15.2 It should also be noted that any reforms could create an uneven playing field. European banks could be at a competitive disadvantage if forced to adhere to EU/FSA/BIS rules globally irrespective of the location of executives. Standard Chartered competes for talent against local banks in Asia, Africa and the Middle East which do not have such constraints. There are also taxation (and securities) issues in many overseas jurisdictions in relation to equity ownership. For example executives may need to dispose of shares to pay for relevant taxes when share awards vest and/or are exercised and potentially subsequently when physical shares are held.

(17) The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register

17.1 We note the recent Proposal for European regulation on improving securities settlement in the European Union and on Central Securities Depositories (the "CSD Regulation"). We welcome the goals of the CSD Regulation in harmonising the regulation of CSDs and improving settlement efficiency across Europe, but are mindful to ensure this is not achieved across the wider European Union at the expense of retrograde steps for issuers or their shareholders here in the UK.

17.2 It is evident from Article 3(1) of the draft CSD Regulation that mandatory dematerialisation of securities will be introduced. We are aware of the benefits that a properly designed and implemented system of dematerialisation can deliver for the UK market; a move which we believe could meet this recommendation 17 of the Kay review. However, in moving to dematerialisation it is important to preserve the advantages of the current UK model, including direct ownership rights, transparency for issuers in relation to who owns their shares, the choice for shareholders regarding ownership arrangements (via an intermediary or directly on the register) and a continued ability for retail shareholders to trade on a "real-time" basis.

17.3 We understand that certain market participants, including the share registrars, are drawing up detailed proposals for how dematerialisation might best be delivered for the UK market and we are broadly supportive of their approach.

Written evidence submitted by Albion Ventures LLP

1. Albion Ventures ("Albion") welcomes the opportunity to comment on the Kay Review of Equity Markets and Long-Term Decision Making.

EXECUTIVE SUMMARY

2. Albion supports the objectives of the Kay Review, and broadly endorses the findings and recommendations of the final report. We believe the review to be an important and timely milestone; one that sets out important principles by which the financial services industry can start to rebuild public trust and promote long-term security across its activities.

3. There are elements within the report to which we would like to respond. Notably, while we agree that measures need to be taken to discourage short-term decision making, we do not believe that mandatory quarterly reporting obligations should be removed. Instead, companies should be encouraged to focus on long-term planning within these reports, moving away from a short-term focus.

4. We welcome the Kay Review's comments prioritising the character and quality of shareholder engagement. In addition, we feel that long-term substantial shareholders should have board representation, building an

informed, trust-based relationship through which they can hold the management to account. We believe it is important for all stakeholders that organisations managing long-term funds adopt a long-term view.

5. Albion itself already meets with many of the suggestions in the Kay report. This in part is due to taking an evergreen approach to funding, reinvesting proceeds for responsible, sustainable capital growth; we have always valued long-term security, performance and relationship continuity over a short term-approach.

6. We also uphold the values of integrity and reliability in our approach to corporate governance, as advocated by the Kay report; the average length of service of senior management at Albion is nine years, and we engage continually with all our stakeholders to enhance standards. Our well-attended shareholder meetings and the overall active, involved attitude of our investor base reflect this emphasis on communication.

ALBION VENTURES' MAIN AREAS FOR COMMENT

QUARTERLY REPORTING

7. Albion supports the Kay Review's general outlook that certain business cultures and practices can increase the pressure to make potentially lucrative but otherwise damaging short-term decisions. However, relating to performance measures the final report recommends that mandatory IMS (quarterly reporting) obligations be removed; grouping them under the umbrella of "excessively frequent" reporting. While we accept that some quarterly reporting will contribute to short-sighted business practices when the content has been "managed" to appear in the most positive light, we do not believe that the procedure should be removed altogether.

8. We feel strongly that shareholders should receive frequent, accurate and objective information, as part of a culture of transparency, inclusion and engagement. This helps to foster informed decision making on the part of an interested, active and long-term minded shareholder base. We believe that more information is better than less, and therefore take the view that quarterly reporting itself is not the root of this issue. Rather, the limiting element has been the nature of that reporting, erring towards the short-term view. We believe that companies should steer their quarterly reporting away from being what the Kay Report terms a "marketing speak" driven means of bringing in more capital, towards something much more balanced, objective and long-term minded. We see this as an important part of the wider shift towards a more responsible financial culture.

9. Additionally, we would like to draw the BIS committee's attention to a reporting model widespread in certain jurisdictions, notably Japan, in which quarterly information includes a rolling 12 month financial forecast. We feel that this model would help to avoid too much very short-term focus; Japanese investors certainly tend to be longer-term minded. Indeed, in the UK such forecasts are already made available to boards, so we believe that expanding this sphere of access to include the general market would be a valuable aid to transparency, and a spur to investors for taking a longer-term attitude.

SHAREHOLDER ENGAGEMENT

10. Albion both endorses the Kay Review's criticism of "shareholder engagement of superficial character and low quality", and agrees with the statement that "equity markets will function more effectively if there are more trust relationships which are based on voice and fewer trading relationships emphasising exit". From our own experience, we firmly believe that inclusive, responsible decision making—based on relationships of real character and high quality—is essential for security and sustainability in the financial services industry.

11. To help achieve this, we would recommend that long-term substantial shareholders should have representation on the boards of companies in which they invest. This practice supports shareholders' understanding of company strategy, gives them the "voice" that the Kay Report calls for, and provides a greater incentive for them to act in the company's long-term interest. Furthermore, it allows longstanding investors to have personal, reciprocal and trust-based relationships with the company management. This is not only a mutually beneficial working relationship, but a mechanism by which shareholders can "hold the management to account" over its actions.

12. Companies and markets are, of course, diverse, both in terms of models and attitudes. As such, there may be some resistance from institutions. However, we firmly believe that quality shareholder engagement is vital; long-term investors should always be considering the long-term interests of the companies in which they hold shares, as this is the practice which offers greatest benefit to all stakeholders.

ADDITIONAL COMMENTS

13. Aside from the main points already outlined, we would like to offer some additional observations. For example, we believe that to facilitate a move away from the culture of short-termism in the financial services industry, the importance of a company's objectives in achieving a stable business environment should be made more explicit. Long-term goals should always be a priority for financial services companies and enhancing the importance of such objectives should enable a switch in focus towards the longer term. This, in turn, should bring stability benefits, both for businesses individually as well as the wider business environment.

14. However, we believe that such changes should be cultural rather than legislative. When it is considering the recommendations of the final report, we would recommend the Business, Innovation and Skills Committee

to be wary of the potential for further legislation creep in subsequent years. It is vital that in the future, would-be investors are not deterred by excessive regulatory red tape or other investment barriers.

15. In addition, while we appreciate the thinking behind the proposal for an Investors' Forum, we question whether the need for collectivising shareholders is an appropriate focus for addressing the "disincentives to engagement" problem which the report describes. We do consider solidarity amongst investors as unnecessary and may even weaken the strength of the shareholder system, namely that shareholders vote and act as individuals.

16. We do request clarification from BIS over the extent of the proposed fiduciary standards recommended by the Kay Review. We would also welcome the opportunity to then comment more fully on this issue at a later date.

THE VCT APPROACH

17. We at Albion believe that the VCT model already meets much of the spirit of the Kay review. Due to the structure of the VCT model and the types of company the trusts invest in, VCT's are often more effective than other types of investment vehicles when it comes to shareholder engagement. In particular, Albion's evergreen approach and our policy of placing appropriately experienced members of staff onto the boards of the companies we invest in, means our shareholders expect us to take a more pro-active approach than is found elsewhere.

18. We strongly believe that long-term relationships are based on good communications and responsible corporate governance. As part of this philosophy, we at Albion remain highly conscious of all stakeholders across the board, from individual investors through to HM Treasury, a highly important stakeholder given the tax incentives that VCTs attract. As such, we greatly welcome the opportunity to continue the dialogue that has been opened by the Kay Review—both with the Government and our shareholders—on the subject of long-term decision making in the financial services industry.

19. Finally, we would encourage the BIS committee to consider the positive examples the VCT model can offer to the rest of the sector when it is analysing the findings of the Kay Review.

20. We are pleased to have had the opportunity to set out these comments on the Kay review. We look forward to the next stage and would be very happy to participate further if the need arises.

Patrick Reeve
Managing Partner
Albion Ventures LLP

17 January 2013

Written evidence submitted by Russell Investments

1. EXECUTIVE SUMMARY

1.1 Russell Investments welcomes the final report of the Kay Review and the Government's response to it, and is pleased to offer this response to the Business Innovation and Skills Committee's "Call for Evidence" issued on 12 December 2012.

1.2 The Review is concerned to address how well UK equity markets are achieving their core purposes:

- to enhance the performance of UK companies; and
- to enable savers to benefit from the activity of these businesses through returns to direct and indirect ownership of shares in UK companies.

Our response focuses on the second of these two purposes from our perspective as a fiduciary manager, asset manager and adviser to the asset owner community.

1.3 The UK equity market is but one component of the increasingly complex investment problem faced by asset owners. Increased complexity has understandably been accommodated through greater specialisation, both within the UK equity savings and investment chain and elsewhere. This has led, as Professor Kay identifies, to the development of multiple specialist firms eg custodians, investment consultants, proxy service providers, stock lenders, to deliver these services.

1.4 This proliferation presents challenges around the control and management of the chain and the array of specialist suppliers to that chain. In this response, we provide evidence that better control can be achieved through:

- further professionalising the asset owner community;
- encouraging structures that allow for more efficient and effective decision-making;
- creating scale within the asset owner community; and
- better aligning of incentives along the chain.

1.5 We submit that simplifying the chain is unlikely to be achievable in the context of the wider investment portfolios of which UK equities form only a part. A focus on ensuring better control and influence is brought to bear on the UK equity component (as well as other components) through the above mechanisms would be a more fruitful policy. We recommend that the Committee considers policy initiatives in these areas as it takes forward its consideration of the Kay Review and the Government's response.

1.6 In particular, we advocate that:

- as part of the response to Professor Kay's recommendation 9 (review the definition of fiduciary duty), the Committee reviews how asset owners can be better equipped to discharge that duty through acquisition of greater expertise, more effective delegation, and development of non-executive, oversight skills;
- as part of the response to recommendation 2 (the adoption of Good Practice Statements), Good Practice Statements are developed explicitly for the growing and diverse "Fiduciary management" segment, which may in the future be in control of substantial portions of asset owners' portfolios;
- the Committee considers policies that would encourage the consolidation of small asset owners to create greater scale in the asset owner community, which would support recommendations for greater engagement and long-term decision-making on the part of asset owners; and
- in considering recommendation 7 (application of fiduciary standards), the Committee specifically addresses the "responsibility gap" that is evident in transactional services, such as FX trading, to the investment chain.

2. CONTROLLING THE INVESTMENT CHAIN

2.1 Professor Kay talks extensively about the investment chain and the number of participants that now exist within the chain. He talks about:

"...the growth of transactional relationships and the erosion of relationships based on trust and confidence—leading to an expansion of costly intermediation activity in the investment chain."

He goes on to argue for an increase in trust and confidence in the investment chain. Whilst we applaud this sentiment we do not necessarily feel that an increase in participants is always a bad thing but we do agree that it is essential to control these participants, either through regulation or through appropriate incentive mechanisms or indeed a combination of the two.

2.2 The complexity of the investment problem faced by asset owners is well documented and so it is not unnatural to expect an increase in the number of specialist skills that are needed to navigate a way through. However the complexity of the system is a challenge and does lead to a wide range of problems. The Royal Society of Arts (RSA) has been developing a body of theory—referred to as "Cultural Theory" that has strong parallels with the problems faced by investors. Cultural theory considers social problems that have complex causes, multiple stakeholders and that are unlikely to be fully "solved" in the foreseeable future.

2.3 The following comments draw heavily on the ideas discussed by the Chief Executive of the RSA, Matthew Taylor in his annual speech to the Royal Society of Arts.¹

"We can also think of social power having three distinct forms: first, the downward power of hierarchical authority associated most strongly with the state; second, the lateral power of solidarity and shared values generally associated with the idea of community; and third, the upward power of individual aspirations..."

"Wicked problems are by definition both tough and multi-faceted so we need to draw on all these forms of social power to tackle them. When progress seems impossible, we revert to a fourth way of thinking about power and change: fatalism."

We can draw parallels between "wicked problems" in a social context and the issues we face in trying to control behaviour in the investment chain.

2.4 Our complex investment problems will not be solved with simple, one-dimensional solutions but require multiple perspectives to come together. In an attempt to find a solution we can begin to shape our answers using the framework of social power.

"...when it comes to complex and contested change, the hierarchical, solidaristic, individualistic and fatalistic perspectives are ever-present as competing diagnoses, dispositions and prescriptions."

2.5 In our case:

- the *hierarchical* power becomes the regulator who adopts the traditional controlling role, acting as a back-stop and creating some freedom for the participants to behave responsibly and differentiate themselves;

¹ Drawing on the work of Mary Douglas

- the lateral power of *solidarity* is the “industry” bodies that have the capacity to stand together and create good behaviour through voluntary codes of conduct. We have already seen good examples of this happening amongst some groups of agents, for example the T-Standard was designed by a group of transition managers to create an industry standard measure of total costs in the transition process (see paragraph 6.9);
- the upward power of *individualism* can be interpreted as the individual investor or asset owners, including collective investment vehicles which generally have a trustee (unit trust) or Board (OEIC) to look after the interests of the investor. The thrust of our individualism must be education; part of the solution is to empower individuals through education so that they can make more informed decisions about their investments. The aim is not to convert them into investment professionals but, at the very least, to help them appreciate such issues as time-horizon and what to expect from different investments.

2.6 The challenges identified by the Review will require each of the three powers; (1) regulators, (2) industry bodies and (3) individual investors and asset owners to input to the solution. We must strive to avoid the fourth way, fatalism, but no one power can affect the necessary change on its own.

2.7 The objective is to achieve greater control of a more complex investment chain, rather than to reduce the investment chain. As the UK equity market is but one component of investors’ challenge, initiatives designed to wind back to a simpler age are unlikely to achieve their aims.

2.8 Controlling longer investment chains requires greater skill, dynamism and dedication relative to simpler, shorter chains. Better control will ensure that each element of the chain is operating effectively, is rewarded commensurately for the amount of value preserved or created, and acts in concert effectively with other components. Effective control will preserve value from company to saver.

2.9 We see four primary means of developing structures which allow for better control:

- Professionalising the asset owner community;
- Encouraging structures that allow for better professional oversight of the assets;
- Creating scale within the asset owner community; and
- Better alignment of incentives along the chain.

3. PROFESSIONALISING THE ASSET OWNERS

3.1 Asset owners, comprising pension fund trustees, insurance companies and other entities which aggregate individuals’ savings, are a key link in the savings and investment chain. Ensuring that these entities are structured and motivated effectively to represent the needs of savers is therefore one of the foundations of success in ensuring the chain works effectively and in the public interest.

3.2 The trustees we work with are vigilant guardians of their beneficiaries’ interests, and the culture and ethos of independent trusteeship is to be cherished. The principles and regulations governing pension fund trustee selection are based on ensuring proper representation of the various stakeholders. This is an important and necessary principle and one that we support. However, stakeholder representation is not a sufficient condition to ensure that the trustee body has the investment expertise and decision-making skills that it requires to effectively oversee and control the investments.

3.3 The Russell survey² of investment decision-making by trustees provides evidence of this. Of the 300 funds surveyed:

- fewer than half have included a professional trustee; and
- out of an average of seven individuals in the trustee body, on average only 2.5 are deemed to have some degree of finance or investment expertise.

Anecdotally, from our experience, those who are deemed to have finance or investment expertise are often representatives of the finance function within the sponsor company. While this ensures a familiarity with the financial perspective and a clear capability to get to grips with the technical aspects, it does not always ensure a long-term saving investment perspective. Indeed, Professor’s Kay’s analysis of the financialisation of companies and the resulting behaviour is illuminating in this regard.

3.4 There are many consequences of this, as was eloquently described by Paul Myners in his 2001 review.³

“at the heart of the system, we often make wholly unrealistic demands of pension fund trustees. Our legal structures put them firmly centre-stage. They are being asked to take crucial investment decisions—yet many lack either the resources or the expertise. They are often unsupported by in-house staff, and are rarely paid.”

² The Evolution of Investment Decision-Making: 2011 Survey of 300 Defined Benefit Pension Funds, Sorca Kelly-Scholte & Shashank Kothare, February 2012

³ Institutional Investment in the United Kingdom: A Review, Paul Myners, 6 March 2001

He argues that, as a result:

- we place a heavy burden on the investment consultants who advise trustees;
- fund managers are being set objectives which, taken together, appear to bear little coherent relationship to the ultimate objective of the pension fund, namely to meet its pension obligations;
- risk controls for active managers are increasingly set in ways which give them little choice but to cling closely to stock market indices;
- there is extreme vagueness about the timescales over which fund managers' performance is to be judged with resulting short-termism in fund managers' approach to investment; and
- fund managers remain unnecessarily reluctant to take an activist stance in relation to corporate underperformance, even where this would be in their clients' financial interests.

These are all observations that resonate strongly with Professor Kay's perspective.

3.5 There is evidence that these shortcomings are costly in performance terms, ie in terms of extracting value from the fund's investments. A study by CEM Benchmarking⁴ finds a positive correlation between governance quality and fund performance: the value added through high quality governance could be as much as 2.4% per annum, adjusted for risk and expenses.

3.6 Lord Myners' diagnosis was that if trustees lack expertise collectively to make a decision, then either they must acquire the necessary expertise or delegate the decision. He made a specific recommendation that trustees should have an investment committee unless there is a good reason not to. Ten years on, the Russell surveys find not only that there remains a scarcity of investment expertise on trustee bodies, but also that little is being delegated:

- Of the funds surveyed, fewer than half (48%) had investment committees: in particular among smaller schemes only 22% reported having an investment committee;
- Across a range of different investment decisions, 70% or more of the respondents indicated that the trustee body retained direct control of that decision.

3.7 Policy response to this has been to encourage the adoption of the Myners Principles that came out of the review (on which there appears to be limited progress, based on the above evidence), and to increase levels of trustee training.

3.8 Unpaid lay trustees can, almost by definition, never become investment experts. Even if this were possible in the past, increased complexity makes it all but impossible today. Trustee training aimed at developing deep expertise across the vast range of investment issues encountered by pension funds is likely to be misplaced effort. Rather, trustee bodies require non-executive skills to discharge their function as overseers of the fund's investments.

3.9 However, in a series of roundtable discussions we held with pension funds,⁵ many funds told us that it was difficult for trustee boards to distinguish between ultimate responsibility for a decision and the ability to delegate immediate responsibility for that decision to someone else. The result is a tendency to retain direct control of much investment decision-making, or to get involved in delegated duties to an inappropriate level of detail, even where the necessary expertise for effective decision-making is lacking. This borne out by the Russell surveys, as described above.

3.10 A corollary of this observation is that training for trustees should focus as much on developing these non-executive skills as it does on educating them about the technical aspects of the various investment decisions for which they retain ultimate responsibility. Currently most training is more focused on the latter, and delivered by agents who are keen to demonstrate their expertise.

3.11 Professor Kay's recommendation 9 focuses on clarifying the concept of fiduciary duty:

"The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers."

In light of the evidence on this section we recommend that alongside this review the government considers how trustees can be better equipped to discharge that duty through acquisition of greater expertise, more effective delegation, and development of non-executive, oversight skills.

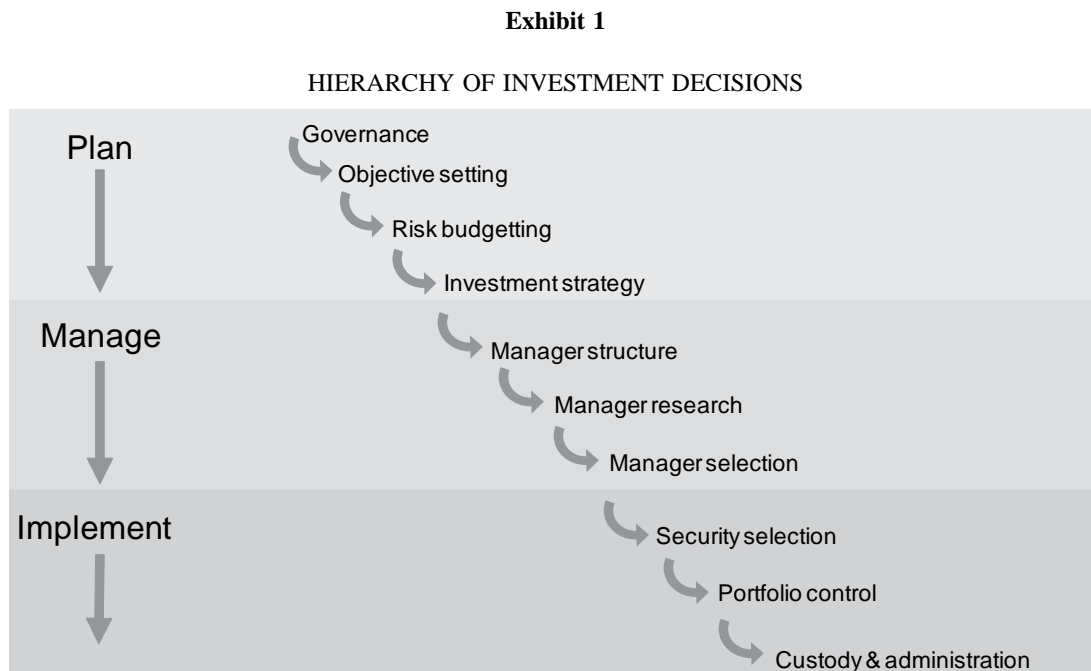
3.12 We have no evidence to suggest that insurance companies and asset owners are not appropriately professionalised. However we note the challenges, by virtue of these entities' ownership, around ensuring that these asset owners are incentivised towards the needs of savers rather than to the commercial needs of providers further down the chain.

⁴ The State of Global Pension Fund Governance Today: Board Competency Still a Problem, Keith Ambachsteer, Ronald Capelle, Hubert Lum, Working Paper June 2007.

⁵ Aspects of Good Investment Governance: Lessons from recent investor roundtables, Don Ezra, Sorca Kelly-Scholte and Shashank Kothare, February 2011

4. ENCOURAGING STRUCTURES FOR BETTER OVERSIGHT

4.1 A number of levels of decision-making are required when managing a pool of capital, such as a pension fund's assets. These decisions are shown in the Exhibit 1 below.



Asset owners are directly responsible for the higher level decisions, which appear in the top left of the exhibit. Investment managers, who manage portfolios of securities, make the decisions towards the lower right of the exhibit.

In the middle, the decisions taken can be described as “executive” in nature. They fall between the “director/board” decisions of the trustees and the “operational” decisions of the investment managers employed. For effective decision-making, the trustees need to both make a small number of high level decisions and also to exercise effective oversight of decisions made by others beneath them in the structure. So, broadly, trustees oversee the executive and the executive oversees the investment managers. The executive can include, for example, an investment committee, as discussed in Section 3 above.

4.2 In our work we often find that inadequate resources are devoted to this executive function. This can arise for a number of reasons:

- there may be unwillingness by trustees to delegate (the ultimate versus immediate responsibility issue described in paragraph 3.9 above);
- corporate streamlining may have removed company executives who in times past would naturally have performed this executive role for the trustees; and
- a strong investment consulting presence, although formally an advisory role, may have taken on a more executive rather than advisory role either implicitly or explicitly, as originally identified by Lord Myners (see 3.4 above).

4.3 One solution is to build an in-house executive. Well-resourced in-house executives are long-established at many of our largest pension schemes, and anecdotally many larger schemes are now seeking to extend their in-house teams. However, the cost of building this level of resource will be prohibitive for the long tail of smaller schemes in the UK.

4.4 The creation of greater scale among asset owners, as discussed in section 5 below, is one means of indirectly encouraging the development of better-resourced in-house executives.

4.5 An alternative response has evolved where some of these decisions are delegated to a third party. Several investment firms with a consulting heritage (including Russell) have offered a manager of investment managers service for some time. Trustees (clients) recognise that they are poor decision makers when investment manager

selection, monitoring and termination decisions are to be made. So the trustees delegate these decisions to expertise, retaining oversight of the appointment of the manager of managers provider.

4.6 Taking this one stage further, some higher level decisions, for example the regional disposition of equity holdings, can also be delegated. In effect, once the broad strategy is agreed the control of the chain implementing the strategy is delegated to a professional third party, and the trustees retain oversight responsibility. Russell offers this service. We believe that, properly structured, this represents an extension of asset owners' fiduciary reach through delegation to a professionalised executive resource.

4.7 The precise formulation of this type of service varies widely, and is now usually referred to as "fiduciary management" or "implemented consulting". Along with new entrants, many asset managers and traditional consultants have evolved their services and business models to provide fiduciary management services. There is evidence of increasing take-up and interest in these types of service, particularly among smaller schemes. The Russell survey of investment decision-making found that 15% of schemes now use some form of fiduciary management, with this figure rising to 26% of the smaller scheme (<£500 million) respondents.

4.8 While representing increased professionalisation and a step-change in the level of resource devoted to high level control of the chain, fiduciary management does present some potential challenges, notably:

- Ensuring that asset owners remain engaged given the increased distance between them and the companies in which they invest;
- Introducing the risk of misalignment of incentives if mandates are poorly specified, or if the fiduciary manager's commercial interests do not align with those of the asset owner.

4.9 The evolution of fiduciary management in the Netherlands, where the concept was first created, is instructive. The early phase of fiduciary management saw a concentration in a small number of providers. A number of disappointments in the outcomes from early fiduciary management could be traced to a misalignment of incentives between the asset owners and the fiduciary management providers, where the providers' commercial interests drove investment decisions that were not consistent with asset owner preferences. This experience has informed the development of the market in the Netherlands. As active participants in this market, we can attest that asset owners look for greater engagement around the mandate definition and accountability, more transparency on portfolio holdings, costs and fees, and independent checks and balances on the activities of the fiduciary manager.

4.10 There are also important variations in the structures under which these types of services are provided. Some are provided under investment management agreements, others under advisory agreements. Accountability and the requirement to act as a fiduciary are clear in the former, less clear in the latter.

4.11 In *Directions for Government and Regulators*, Kay recommends that regulation should emphasise issues of structure and incentives rather than control of behaviour. We strongly endorse this recommendation, and would suggest its applicability in the context of our comments in this section. In particular, we encourage the creation of Good Practice Statements for this growing and diverse segment which may be in control of substantial portions of asset owners portfolios.

5. CREATING SCALE IN THE ASSET OWNER COMMUNITY

5.1 Professor Kay observes that the UK equity investor community is fragmented. This fragmentation is in evidence in the asset owner community. For example, the vast majority of UK defined benefit schemes are small: the 2012 Purple Book published by The Pensions Regulator indicates that out of a total of 6,316 schemes included in its dataset:

- 2,260 have fewer than 100 members;
- 2,828 have between 100 and 999 members; and
- (the remaining 1,228 have at least 1,000 members).

Given that the vast majority of UK defined benefit schemes are now closed to new members or future accrual, funds are set to get even smaller in the future. The defined contribution segment is further fragmented between contract-based and trust-based arrangements, and asset sizes as yet remain considerably smaller than for defined benefit schemes.

5.2 As well as more efficient cost structures, larger asset owners tend to have stronger governance. For example, the Russell survey of investment decision-making found that larger funds:

- have better access to expert resource and advice: taking together the number of finance or investment professionals on the trustee body or the investment committee, as well as any full-time in-house investment staff:
 - funds with assets in excess of £500 million have on average five expert individuals; whereas
 - the smallest funds (<£100 million) with less than £100 million in assets have only 2.5 individuals;
- are more likely to have an investment committee:

- 69% of large schemes (>£500 million) have investment committees; versus
- just 22% for small schemes (<£500 million).
- spend more time in absolute terms on investment issues: trustee boards and their investment committees spend:
 - just over 25 hours a year on investment issues for larger funds (>£500 million); versus
 - just 7.5 hours for the smallest funds (<£100 million).
- are more likely to have a more ambitious investment strategy: measured on complexity scale from 0–100 (least to most complex):
 - large funds (>£500 million) score 69; versus
 - 44 for the smallest funds (<£100 million).

As such, larger funds are better placed to control the investment chain and ensure that value is preserved for the end saver.

5.3 We submit that these larger fund scale efficiencies enable some, but quite a small proportion, of asset owners to engage more effectively with a number of the recommendations made by Professor Kay: for example developing and promoting a more expansive form of stewardship (Recommendations 1 & 2), participating in a forum for collective engagement (Recommendation 3).

5.4 Smaller asset owners could be encouraged to merge to facilitate the creation of scale. In several other countries, notably the Netherlands and Scandinavia, there has been strong encouragement for such smaller schemes to merge or pool their resources in industry-wide plans. In Australia, market forces have consolidated super funds to the point where there are very few small operators left. Current UK legislation makes it possible for smaller plans to join together, but there has been very little movement in that direction. We propose that the government considers incentives that would encourage consolidation. This aligns with Kay’s diagnosis that policy should focus on issues of structure. We expect that this would require a review of trust law and potential legal obstacles to consolidation, where we are not competent to comment further.

6. BETTER ALIGNMENT OF INCENTIVES ALONG THE CHAIN

6.1 Alignment of interest along the investment chain is patchy at best. The current system of incentives motivates participants to focus either on revenue (profit) maximisation, at the expense of investment outcomes for the investor, or on a time period that is far shorter than is optimal for most investors.

6.2 The problems with our current system on incentives can be separated into two distinct areas:

- the timing issue, where parts of the investment chain are incentivised to maintain a short-term focus, despite the ability of investors to take a long-term view, and
- the reward issue, where asset managers and agents are incentivised to behave in a way that is not always in the best financial interests of the investor.

These issues are all well understood by Professor Kay and a number of examples of this type of behaviour are highlighted throughout his report and the Government’s response.

6.3 The timing issue arises in a variety of different situations in the world of pension financing. Trustees are currently driven to focus on the short-term impact of market related valuations on their funding level (and hence the sponsor’s balance sheet) rather than on their real responsibility which is to provide the actual pension payments to beneficiaries; a series of, as yet, unknown payments over 40 or more years. Such a long-term investor would not necessarily wish to focus on government bonds when yields are so low if it felt there was a better chance of generating appropriate income streams from other assets, albeit that the value of such assets might suffer greater short-term volatility.⁶ Current regulatory and accounting practice encourages the short-term funding level volatility perspective, and the banking community has further encouraged corporate sponsors to adopt this perspective. This is one instance of what Professor Kay describes as “sales masquerading as advice”.

6.4 This short-term focus is also encouraged by the business models of asset managers who are generally incentivised to maximise the volume of assets they gather rather than focus on good, long-term outcomes for their investors. Their behaviour is designed to attract and then retain assets. Behavioural studies amongst retail investors demonstrate that they tend to invest new money in the latest hot performer but rarely move money away until the performance is significantly below benchmark. A successful manager need only produce short bursts of good performance to attract assets and hence profits and then seek to avoid the sort of underperformance that would cause those assets to be lost.

6.5 As Kay recognises, one of the main stumbling blocks in trying to change this behaviour is the concept of fiduciary duty. Many participants in the investment chain constrain themselves within a very narrow interpretation of fiduciary duty based on previous judgements, particularly *Cowan v Scargill* [1985], which many advisers have taken out of context and used to focus attention on short-term underperformance rather than the potential for long-term outperformance. If fiduciary duty is used to penalise a manager for following

⁶ Help! We are running out of gilts, Sorca Kelly-Scholte, February 2012

a good long-term theme that lags behind their peer group in the short-term then it is no surprise that their behaviour is adversely affected.

6.6 Conversely a lack of fiduciary care is the key culprit in a number of areas where the behaviour of third party agents engaged in the investment chain has come under scrutiny. In particular we see some evidence of “sharp” behaviour in the areas of currency management where the exchange rates charged to investors look suspect compared to what might have been achieved elsewhere in the market at the time. Studies by Russell have estimated the cost of this sharp practice to asset owners to be of the order of nine basis points per annum.⁷

6.7 However it is not all bad news. In some areas, the industry has acted on its own to improve the behaviour of agents. For example, the leading players in the transition management industry have come together and have created the T-Standard, an industry standard for measuring total costs during the transition process. This initiative has significantly improved transparency around the whole process of moving from one manager to another.

6.8 Another example of behaviour that is not aligned along the investment chain is the concept of “closet indexing”. Professor Kay observes:

“...that some active asset managers, faced with the need to deliver short-term relative performance, will resort to ‘closet indexing’, ie selecting and managing their equity portfolio to minimise tracking error from their performance benchmark.”

This is one of the reasons that has been cited as an explanation of why low risk stocks have not underperformed high risk stocks. The risk adjusted return premium associated with low volatility stocks is well documented.⁸ One of the most plausible explanations is that stocks with low absolute volatility introduce into a portfolio a high level of risk, relative to the benchmark against which managers are monitored. Asset managers are thus inclined to ignore an area of the market that could provide better outcomes for their investors.

6.9 As such we strongly endorse Professor Kay’s recommendations for the clarification of fiduciary duty (Recommendation 9), and the application of fiduciary standards to all relationships in the investment chain (Recommendation 7). Encouraging a truly long-term focus on investment-decision making requires that focus to come from all parts of the chain. We have focused on the primary controllers of the chain, the asset owners, earlier in this submission. We further recommend that the Committee specifically addresses the “responsibility gap” that is evident in transactional services, such as FX trading, to the investment chain.

7. ABOUT RUSSELL

7.1 Russell Investments (Russell) is a global asset manager and one of only a few firms that offer actively managed, multi-asset, multi-manager portfolios and services that include advice, investments and implementation. Working with institutional investors, financial advisors and individuals, our core capabilities extend across capital markets insights, manager research, portfolio construction, portfolio implementation and Indexes.

7.2 As of 31 December 2012, we managed over \$162 billion in assets for 2,400 institutional clients, and over 580 independent distribution partners and advisors globally. We advise \$2.4 trillion in assets (as of 30 Jun 12). We have researched investment managers for forty years, in recent years meeting annually with more than 2,200 managers around the world. Through our implementation services business, we traded more than \$1.5 trillion in 2011.

7.3 We are headquartered in Seattle, Washington, USA, and also have offices around the world including Amsterdam, Auckland, Beijing, Chicago, Dubai, Frankfurt, London, Melbourne, Milan, New York, Paris, San Francisco, Seoul, Singapore, Sydney, Tokyo and Toronto.

8. SUMMARY

8.1 Russell Investment welcomes the final report of the Kay Review and the Government’s response to it, and supports the Review’s recommendation the regulations should emphasise issues of structure and incentives rather than control behaviour. We have focused in this response on how better control on the investment chain should be encouraged, and the structures which are in place to control that chain.

8.2 We find evidence that there are potential benefits from:

- further professionalising the asset owner community;
- encouraging structures, for example in the fiduciary management segment, that allow for more efficient and effective decision-making;
- creating scale within the asset owner community; and
- better aligning of incentives along the chain.

8.3 In particular, we advocate that:

⁷ Still overpaying for FX?, Lloyd Raynor, May 2012

⁸ Defensive Equity: is the market mispricing risk? Bob Collie, John Osborn, July 2011

- as part of the response to Professor Kay’s recommendation 9 (review the definition of fiduciary duty), the Committee reviews how asset owners can be better equipped to discharge that duty through acquisition of greater expertise, more effective delegation, and development of non-executive, oversight skills;
- as part of the response to recommendation 2 (the adoption of Good Practice Statements), Good Practice Statements are developed explicitly for the growing and diverse “Fiduciary management” segment, which may in the future be in control of substantial portions of asset owners’ portfolios;
- the Committee considers policies that would encourage the consolidation of small asset owners to create greater scale in the asset owner community, which would support recommendations for greater engagement and long-term decision-making on the part of asset owners; and
- in considering recommendation 7 (application of fiduciary standards), the Committee specifically addresses the “responsibility gap” that is evident in FX trading and other transactional services to the investment chain.

Mike Clark, Sorca Kelly-Scholte and Crispin Lace

January 2013

Written evidence submitted by Aviva plc

EXECUTIVE SUMMARY

As the UK’s largest insurer and owner of a global asset management business with assets under management in excess of £370 billion, Aviva is able to speak as both the owner of, and investor of capital in the market.

We welcome the opportunity to participate in the Committee’s inquiry into Professor Kay’s Review and the Government’s response. We believe that, although Professor Kay produced a thorough and thoughtful analysis of the causes of short-termism in the equity markets, the study failed to fully examine the role of other participants in the investment chain that have a significant influence on the way companies are structured and develop their strategies.

Both Professor Kay and the Secretary of State have made several welcome proposals, for example on narrative reporting, ending quarterly reporting and the establishment of a new investment forum to reinvigorate collective engagement. We welcome these proposals as they fit with our investment beliefs, which are centred on being long term, engaged, active investors running low turnover, focused portfolios.

However, by failing to provide recommendations that address all the participants that influence the investment chain, or its inherent tensions and commercial conflicts, neither the review nor the government’s response sufficiently address the underlying causes of why the market is so short term. For example, it misses the opportunity to encourage investment consultants to oversee the way asset holders and their managers engage in stewardship and to examine the significant role played by sell side brokers.

This submission will give a brief overview of the causes of short termism in the capital markets and will then take each Kay recommendation in turn that we believe should be revised or expanded and will conclude with a series of policy recommendations to the Committee.

1. INTRODUCTION

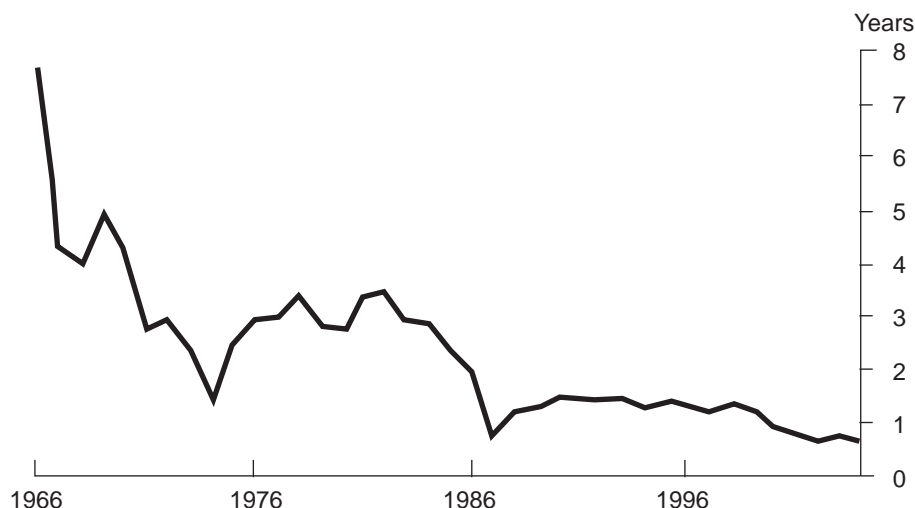
1.1 As a largely long-term, risk-averse equity investor, we are investing for our clients for the long-term. Looking at the broader dynamic in the capital markets, however, the pressures are clearly to the short term, which ultimately affects both investor and company behaviour.

1.2 We therefore welcome the debate about the role that long term investors should play in terms of stability, enabling corporations to focus on long-term strategic decisions and supporting economic growth. This must be significant if good long-term corporate investment opportunities (requiring a higher initial capital investment) that have a lower expected return, but a higher NPV (increase in shareholders’ wealth), are being passed up for faster and less value added alternatives.

1.3 At a headline level a distinction needs to be drawn between those who mainly trade shares and those who commit material amounts of capital to companies through the markets. Proprietary and principle traders that buy or sell equities or substitute instruments, often with their own capital, including hedge funds and others with very high portfolio turnover, such as high frequency traders, tend to be driven by short term market trends and turn over their portfolios rapidly. Those that invest will also buy and sell equities but tend to hold them for the long term based on their analysis of the prospects of the company and their perception of the underlying performance.

1.4 The Bank of England’s Andrew Haldane has highlighted⁹ the sharp decline in average holding periods for UK equities since the mid-60s from a period of almost eight years to just seven and a half months in 2007, a trend that is reflected in the US and other international equity markets:

⁹ “Patience and Finance” (September 2010), Bank of England



Source: London Stock Exchange

1.5 However, the seven and a half month figure does not offer a clear insight into the current state of play. Data from Tabb Group, UK National Statistics and the London Stock Exchange, shows that about two thirds of the turnover in UK equities is accounted for by hedge funds and high-frequency traders. By contrast the average holding periods of more traditional long-only funds in the past decade, who hold a more significant proportion of assets, have varied from 29 to 46 months, although this is still less than it was in the mid-60s.

1.6 Amongst the issues that the review highlighted, of particular interest in this context was the impact of technological advances and automated trading on investment. We believe that this dynamic and the developments that have been seen not only in the context of high frequency trading but also financial product development are particularly significant elements of the short-term orientation of the capital markets.

1.7 Looking back at the origins of high-frequency trading, after London moved from the trading floor to electronic trading in 1986, in what was known as the Big Bang, the average number of daily trades at the London Stock Exchange rose from around 20,000 trades to 839,244 with a peak in excess of 900,000 in 2007, although the crisis has impacted that trend. This is just the market equity volume and does not capture the full picture of related trading in, for example, contracts for differences (CFDs) and other related instruments. It is important, therefore, to recognise the range of parallel and connected trading strategies that exist and the fact that by 2007 Europe had become the most important region in the global derivatives market, with 44% of the global outstanding volume (significantly higher than its share in equities and bonds).

1.8 Compared to estimates of 35% to 60% in the UK, in the US capital markets, it has been suggested that HFT can account for up to 56% to 75% of dollar trading volume in US equities.¹⁰ The US Flash Crash in May 2010 was foreshadowed in the Black Monday crash of 1987. Computerised trading, high frequency traders and what is known as “order flow toxicity”,¹¹ have been attributed with creating the biggest one-day point decline on an intraday basis in Dow Jones Industrial Average history.¹²

1.9 While proponents of high-frequency trading argue that it provides liquidity to the market, there is evidence to the contrary.¹³ Amongst other issues, not only is high-frequency trading positively correlated to share price volatility,¹⁴ which HFTs exploit aggressively, but the general liquidity argument (clearly not borne out in the flash crash) is called into question. However, this must not be taken to mean that all short term investment activities are a problem, although valid concerns continue about the volume and impact of HFT.¹⁵

1.10 There is also the risk that high frequency traders can create mispricing which is then exploited to the disadvantage of ordinary investors.¹⁶

1.11 We therefore feel that steps need to be taken to curb the focus on and trends around HFT that seem to dominate the capital markets, although we are firmly opposed to the EU’s proposed Financial Transaction Tax, which would be both damaging to long term risk averse investors and London, as well as ineffective in raising the (net) revenues envisaged (See Appendix 1). More broadly, these issues form part of the wider, inherent or

¹⁰ See for example: <http://www.bloomberg.com/news/2011-10-05/with-high-speed-trading-market-cannot-hold-commentary-by-mark-buchanan.html> or <http://xtiburon.com/finance/how-high-frequency-trading-affects-the-market/>

¹¹ “The Microstructure of the „Flash Crash: Flow Toxicity, Liquidity Crashes and the Probability of Informed Trading” (2011) Easley et al, *The Journal of Portfolio Management*, Vol. 37, No. 2

¹² “Findings Regarding the Market Events of May 6, 2010” (Sept 2010), US SEC and CFTC

¹³ “High Frequency Trading, Stock Volatility and Price Discovery” (2010), F Zhang, Yale School of Management

¹⁴ See also “An Empirical Study of Volatility and Trading Volume Dynamics Using High-Frequency Data” (2010) Lu and Lin; “High Frequency Traders, News and Volatility” (2011) Martinez and Rosu; and “Where is the Value in High Frequency Trading” (2011) Cartea and Penalva

¹⁵ e.g. “High Frequency Trading: The growing Threat of Rogue Trading” (2011) Weber, London Business School

¹⁶ “A Dysfunctional Role of High Frequency Trading in Electronic Markets” (2011), R Jarrow and P Protter

endogenous risks that financialisation, the increase in speculation and decrease in investing, the growth of derivatives and use of leverage, the practice of shadow banking and lack of transparency, and institutions that are “too big to fail” all link together to create.

1.12 The practical issues for long-term investors, the trends being seen in asset allocation, and the issues of myopia and short-termism are apparent not only in the market’s increasing focus on high frequency trading, the broader level of portfolio turnover and falling holding periods, but also in the incentives of both market participants and corporate managers.

1.13 Dynamics such as short corporate reporting cycles/milestones and short-term performance measurement of investment portfolios are factors that both feed off and contribute to the short-term orientation of the capital markets and, in some cases, the behaviour of companies.

1.14 As the regulatory and standards frameworks, incentives and practice have all converged towards accommodating shorter time horizons, behaviours have normalised around and exacerbated that and the dynamic has become self-perpetuating, with increasing emphasis on immediacy and trading. This was neatly summed up by the founder of one US trading house who observed, in the context of the US flash crash, that “Over \$1 trillion of market value evaporates in less than 15 minutes and people say, “Who is to blame?”. No one is to blame. This is the market that we have. This is the by product of a market structure that has gone horribly wrong.”¹⁷

1.15 A recent McKinsey survey¹⁸ found that most executives believed that their companies were too loss averse in their approach. Two-thirds of the respondents indicated that their companies underinvested in product development,¹⁹ and more than half that they underinvested in sales and marketing and in the financing of start-ups for new products or new markets. This should be of significant interest to policymakers as, as the authors note, these are not just missed opportunities for individual companies: the investment dearth hurts whole economies and job creation efforts as well. To solely blame the capital markets, however, would be unreasonable; they are one piece of the jigsaw.

2. THE STEWARDSHIP CODE

2.1 The Kay Review recommended that the Stewardship Code should be expanded to focus on more strategic issues as well as corporate governance. An interest in and assessment of strategy, competitive positioning, operational efficiency and the leadership of businesses, clearly form part of the active investment process and approach we deem necessary for long-term investment.

2.2 The Stewardship Code sets out clear good practice and although there are clearly examples of effective practice and activity in equity investment, the integration of stewardship activities and what those activities are deemed to involve varies between fund management houses. Except for the most focused funds and listed turnaround vehicles, which often have highly concentrated portfolios and a relatively high level of resource per investment, the levels of resource that are available or indeed viable mean that a selective approach and prioritisation is needed. This is particularly true when spread across hundreds or indeed thousands of investments globally.

2.3 The take up and/or disclosure on the Code by asset owners has been more muted than amongst asset managers. This is an area where considerable uncertainty and lack of conviction still exists. Policymakers need to build on the solid foundations provided by the UK’s Stewardship Code and, amongst other things, the Pensions Regulator should be asked to re-examine its own regulations and to re-task its Investor Governance Group to take a more proactive interest and review their guidance around the Myner’s Principles. This work should also take account of market developments and how these frameworks should accommodate trends, such as that towards Fiduciary Management.

2.4 Furthermore, policy-makers should establish mechanisms that promote, encourage and require investors to maintain an appropriate oversight role of companies; for example, investors could be required to publicly disclose their voting record and pension trustees to report to their beneficiaries on how their ownership rights have been exercised.

2.5 There should also be regulatory enforcement measures of the stewardship codes and improved accountability of voting agencies, which have considerable power to either influence or control a substantial portion of the market at shareholder meetings. The voting recommendations of voting agencies are based on best practice, but cannot take sufficient account of individual circumstances. In some instances, this creates a box-ticking approach to corporate governance. This situation could be improved if proxy voting agencies were to explain their processes and explain the rationale for their voting decisions.

2.6 Responsible ownership is a non-excludable public good, ie the benefits of engagement are enjoyed by all owners regardless of whether they behave as responsible long term owners. Consequently, the vast majority of profit maximising commercial fund management institutions free ride and either do not do stewardship at

¹⁷ “Speed-addicted traders dominate today’s stock market” (2010) Los Angeles Times—http://www.themistrading.com/article_files/0000/0557/051610LosAngelesTimes.pdf

¹⁸ “A bias against investment?” (2011), Kholler et al, McKinsey Quarterly

¹⁹ In this context see: “Innovation and Performance in British-based Manufacturing Industries—a Policy Analysis” (2002) Cox and Frenz

all, or invest only token resources in this work. Professor Kay’s review does not consider how to significantly increase either the economic demand for, or the financial funding of stewardship. In general, it is assumed that fund managers will be responsible and accept their public interest role for them to conduct stewardship and voluntarily invest more in their stewardship work. This is misguided at best and economically naive at worst.

2.7 Fortunately, as Professor Kay recognises, there is no shortage of money in the system for financing the work of the various market intermediaries; global commission spend is between \$25–\$33 billion²⁰ In the UK, commission flows are overseen by the FSA and to control what fund managers spend this money on, the FSA has established a series of tests that fund managers have to apply before funding their research with commission (as this is generated from a small percentage charge on their client’s assets under management rather than from their own balance sheet).

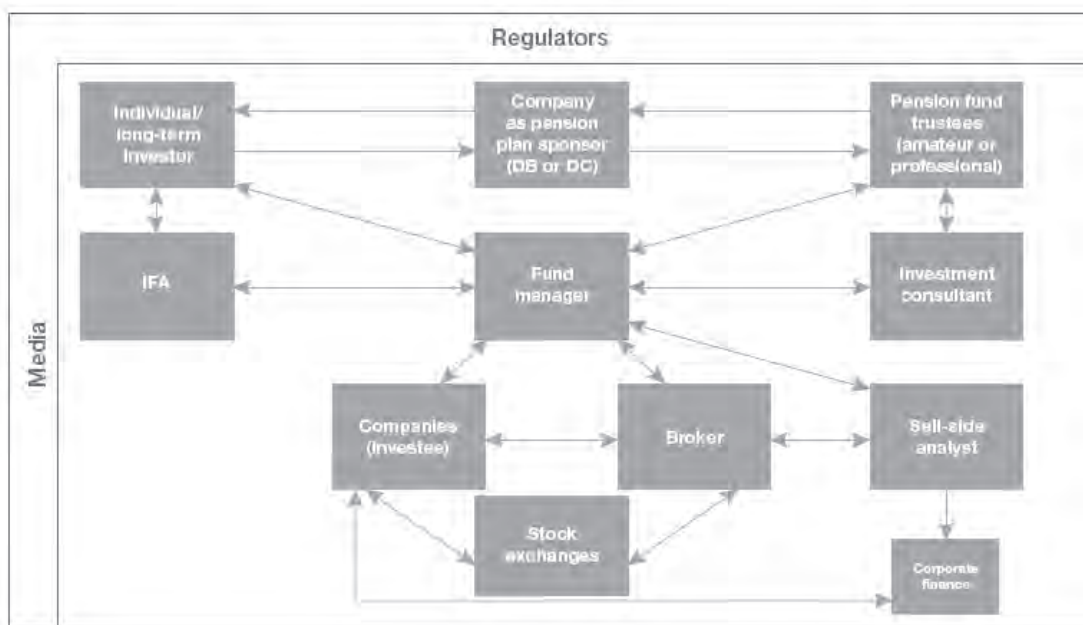
2.8 A few fund managers—including Aviva Investors—are directing this research commission towards brokers and independent research providers of long term investment research, voting advice and stewardship work. We are clear that investment stewardship passes these tests and adds value to investment decisions.

2.9 We believe that if policy-makers were to take the following four steps, then it would significantly increase the scale of stewardship resources in the market and fundamentally transform the delivery of long term investment analysis and investor stewardship:

- I. Policy-makers could clarify that long term investment research that is orientated towards good stewardship behaviour by investors can be paid for in this way.
- II. Policy-makers could suggest as a guide that it is good practice for a material proportion of the commission research (say 10–25%) to be spent in this way.
- III. Policy-makers could say that it is good practice for fund managers to be transparent to their clients that this was taking place.
- IV. Policy-makers could say that it is good practice for clients to be allowed to opt out of this, as long as they are clear to their beneficial owners what their rationale is for so doing.

3. GOOD PRACTICE STATEMENTS FOR COMPANY DIRECTORS, ASSET MANAGERS AND ASSET HOLDERS

3.1 The Good Practice Statements are welcome but fail to cover all relevant players in the capital market. The below diagram represents the impacts and interactions of incentives across the capital system. The arrows represent the direction of these impacts:



Source: Tomorrow’s Company, 2012

²⁰ Source: Frost Consulting, July 2012

3.2 Tomorrow's Company conducted a piece of research on potential issues for long-term stewardship and the alignment of incentives in partnership with Aviva Investors and found that potential conflicts of interest included:

3.2.1 Pension fund trustees and investment consultants

- Investment consultants tend to charge a fixed hourly rate and therefore have an incentive to be active in order to maximise their income. They therefore offer an increasingly wide range of services that they encourage trustees to use.
- Pension fund trustees will monitor the performance of their investment consultants according to a number of criteria that are not generally related to the fund's performance. It can be argued that this is necessary as investment consultants are not the investment decision-makers, but it does create a misalignment of interests.
- The degree to which investment consultants take into account factors relating to the long-term sustainability of companies is dependent on: the degree to which pension fund trustees wish to take them into account; and the cost of maintaining dedicated research teams and the lack of good long-term comparable data.

3.2.2. Investment consultants and fund managers

- Investment consultants have differing views on the key aspect of their role which adds most value for their pension fund clients. Some believe it is through advice on asset allocation while others believe it is through the fund manager selection process.
- There is an opportunity to generate substantial income through the fund manager selection process, so consultants may be incentivised to encourage fund manager turnover.

3.2.3 Pension fund trustees and fund managers

- The close and frequent monitoring of fund management performance by trustees can result in fund managers feeling pressured to maintain high levels of short-term performance relative to the benchmark to retain funds.
- 66% of pension funds formally review fund manager performance every quarter (92% annually or less), despite the key investment period for trustees appearing to be longer than a rolling or calendar year for 62% of them.²¹ This can create incentives that affect fund managers' approach to risk taking.

3.2.4 Sell-side analysts, brokers and fund managers

- Brokers' remuneration is directly tied to trading volumes. As a result they have a powerful incentive to encourage market activity.
- Even when sell-side analysts are aware of corporate governance or sustainability concerns, these analysts do not report this in their reports to buy-side analysts for fear of losing access to those boards

3.2.5 Corporate financiers and sell-side analysts

- As highlighted by the SEC in the US, analysts who work within the umbrella of a larger investment bank may have a potential conflict of interest around IPOs and new rights issues. The existence of such a relationship should not be taken to automatically mean an analysts' research is biased as there are strict codes of conduct, but research has shown that analysts may still feel under pressure to produce positive reports on the client company.²²

3.2.6 Corporate financiers and investee companies

- Corporate financiers' incentives are weighted towards deal completion. This can lead to a misalignment of interests as investment bankers' motivation to complete a deal may ignore what is in the longer-term interests of the company and its shareholders.

3.2.7 Fund managers, stock exchanges and investee companies

- Nearly half of all exchanges are companies listed on their own exchange and are therefore subject to shareholder pressure to maximise returns. The largest sources of revenue for demutualised, for-profit stock exchanges are reliant on market activity. This results in an incentive for exchanges to create inducements for trading activity.

3.3 In short, there is a lack of alignment between incentives, the interests of beneficiaries and business strategy. The criteria on which performance and hence reward is based are still too often founded on excessively short-term measures.

3.4 Simple measures could be implemented to align these incentives, for example: fund manager performance should be reviewed over longer time horizons than the typical quarterly cycle; excessive reliance on measuring performance relative to a market index should be reduced; pension funds should have voting and engagement policies that should be integrated into the investment process; shareowner activism should be given more weight in the selection and retention of fund managers and other matters; all advisors to institutional investors

²¹ "NAPF/IMA Short-Termism Study Report" (2004) MORI

²² See: US Securities and Exchange Commission. "Analysing Analyst Recommendations". Available at: <http://www.sec.gov/investor/pubs/analysts.htm>

should have a duty to proactively raise ESG issues and encourage adherence to the Stewardship Code; fund management contracts and fund managers' performance should include an evaluation of long-term ability to beat benchmarks; investment consultants' fee structures should not reward them for moving clients between fund managers; and within companies the implementation of strong cultural norms should be supported by independent whistleblowing mechanisms, overseen by professional bodies who offer the whistleblower appropriate protection.

4 THE SCALE AND EFFECTIVENESS OF MERGER ACTIVITY OF AND BY UK COMPANIES SHOULD BE KEPT UNDER CAREFUL REVIEW BY BIS AND BY COMPANIES THEMSELVES;

4.1 The role of incentives in this context is particularly important. Half or more of the mergers, acquisitions, and alliances that take place, fail to create significant shareholder value both in our experience and according to much of the research that has been undertaken on major deals.²³ For some time now, academics have flagged that company size is the factor that has the highest and most significant positive correlation with levels of executive pay.²⁴ This is echoed in academic work on UK M&A,²⁵ which has highlighted the significant and substantial executive pay increases, in excess of those generated by the growth in firm size, consequent upon mergers.

4.2 A way needs to be found to break this dynamic and re-align the incentives and economic interests of all participants in taking a longer-term approach. This applies not just to capital markets participants but to Boards of directors and their remuneration committees.

5 ASSET MANAGERS SHOULD MAKE FULL DISCLOSURE OF ALL COSTS, INCLUDING ACTUAL OR ESTIMATED TRANSACTION COSTS, AND PERFORMANCE FEES CHARGED TO THE FUND;

5.1 Looking at the question of whether and how asset managers should be more transparent, we quite understand the concerns around, for example, some fee structures.²⁶ This broad area is one that we are generally interested in seeing explored and debated further.

5.2 We support the Good Practice Statements recommended by Professor Kay and welcome the initiatives on cost transparency by the ABI and the Investment Managers Association and are complying with both.

6 MANDATORY IMS (QUARTERLY REPORTING) OBLIGATIONS SHOULD BE REMOVED;

6.1 We welcome the proposal to amend the Directive on Transparency Requirements for Listed Companies so that the requirements to produce interim management statements and quarterly reports are abolished. Such short term reporting cycles contribute to short-term thinking and can discourage investment for the long-term, given the impact that could have on short-term performance. It is also important to recognise the effects of peer pressure and competition between companies in this context.²⁷

6.2 Unilever Plc is often cited as an example of the hurdles companies have to overcome and mindset needed in breaking away from short term dynamics. Their move away from providing regular short-term guidance to embed a longer-term approach and practices was welcome and interesting. Initially the response from short term investors pushed the share price down around 10%, but it subsequently outperformed.²⁸ This highlights the importance of recognising that the dynamic here should not be characterised as just a capital markets issue. Unilever is not alone though in having sought to face up to this challenge and, looking at more cyclical businesses, others that would be worth exploring the issues with might include Aggreko Plc or Marshalls Plc.

6.3 On reporting more widely, the International Financial Reporting Standards (IFRS) are pro-cyclical in nature and played a notable role in facilitating and exacerbating both the dynamic and behaviours that drove the credit bubble and the subsequent crisis. Despite a common assertion of some standard setters, IFRS are not just presentational, they have real world effects, not just for pensions, capital management, behavioural biases, risk taking, and ability to be prudent but also, and not least, financial product innovation. The effects and problems have arisen both as a result of how the standards have been implemented and their effects on accounts. Not least, critical concepts like prudence and accounting conservatism have been superseded by a compliance orientated model. Concepts like the "true and fair view" have also been diluted. IFRS compliance allows significant discretionary scope within fair values. The standards have also resulted in the Companies Act accounting requirements being obfuscated, eg in relation to distributable reserves and dividends. From an investor perspective, a significant proportion of bank capital raising over the crisis went to redress precisely the results of that.

6.4 Looking at the broader accounting frameworks, long-term investors are interested not just in the decision usefulness model pursued by accounting standard setters, which is more orientated towards the trading markets

²³ See "Deals that create value" (2001) Biesharr et al. or "Why do acquisitions so often destroy Shareholder Value?" (2002) PA Consulting Group or "Deals from Hell: M&A Lessons That Rise Above the Ashes" (2005) R Bruner

²⁴ "How Much Does Performance Matter? A Meta-Analysis of CEO Pay Studies" (2000) Tosi et al.

²⁵ See for example "Merger Activity and Executive Pay" (2002) Gima et al.

²⁶ "Fund Management Fees" (2010) Terry Smith (<http://www.terrysmithblog.com/straight-talking/2010/09/fund-management-fees.html>)

²⁷ See for example <http://www.ft.com/cms/s/0/5d6c466c-6a00-11e0-86e4-00144feab49a.html#axzz1dOaOWc00>

²⁸ http://www.mckinsey.com/en/Features/Capitalism/Paul_Polman.aspx

than it is to corporate stewardship or to long-term ownership and investment. As the preliminary report of The Sharman Inquiry²⁹ noted, investors and “quite a lot of others” have raised questions about the suitability of IFRS accounts as a basis for assessing the solvency of businesses. As the report notes, overall, capital management is important to us as shareholders. However, IAS 1 disclosures are not generally providing what long-term shareholders want, although they could in theory be used to do so.

7 HIGH QUALITY, SUCCINCT NARRATIVE REPORTING SHOULD BE STRONGLY ENCOURAGED;

7.1 It is extremely difficult for any within the investment chain to demonstrate the value of non-financial information without widespread reporting on these areas by companies, in accordance with a consistent framework and standards.

7.2 Information should be disclosed in an integrated manner with strategy, risk and performance on: remuneration and incentive plans, material sustainability issues and the culture and values of a company.

7.3 The current framework and practices mean that many companies are failing to provide the level of information needed for investors to be able to judge the sustainability of businesses, affecting long-term strategic analysis. Globally, of 20,000 publicly listed companies recently reviewed through Bloomberg’s database, less than one in five publicly reported on even a single item of quantitative data on environmental, social or governance issues.³⁰

8 REMUNERATION

8.1 Most institutional client mandates tend to run for a minimum of three years. However, despite the long term nature of the liabilities institutions face, a norm for fund manager incentives is to have one- and three-year rolling performance horizons, ie the short and medium term, but not the long term. Although the dynamic is not always so simple, asset managers know that if they under-perform for a short period within this time they could be replaced. Therefore, some asset managers may take risks to get the required returns over a shorter time frame.³¹ Efforts, such as that of the Universities Superannuation Scheme, have been made in the past to devise longer term mandates but the need to plug pension scheme deficits has, in recent times, been the greater priority and so aggressive pursuit of short term performance continues.

8.2 According to National Employment Savings Trust (NEST) chief investment officer, Mark Fawcett, improving companies through corporate governance will remain “a fantasy” until pension trustee’s better align their managers’ incentives. Speaking at the OECD—WPC World Pensions and Investments Forum in December 2010, Fawcett suggested that pension scheme trustees are too focused on short term returns by hiring and firing fund managers on a three year cycle, whereas they should be looking at five years as a minimum, maybe ten. Fawcett maintains that “until pension funds start behaving the right way by aligning the incentives for fund managers... the idea that corporate governance is going to make a change is unrealistic.”³²

8.3 We believe that some Trustees consider it just as much a risk to award long term mandates as to not remove under-performing fund managers before their mandates are completed. However, as it takes time to discern the extent to which a fund manager’s performance is attributable to luck or skill, we consider it often inappropriate for managers to be judged solely on their short term performance. Indeed, over time as luck evens out, skill, where it exists, will shine through. Academics have, in the past,³³ examined the process in which asset owners hire and fire their fund managers and found a tendency to hire managers who had recently performed well and fire managers who had recently performed badly. The point of note was that the fired managers, on average, subsequently outperformed those hired, albeit marginally, notwithstanding the sizeable transition costs incurred in changing managers.

9. RECOMMENDATIONS

There are four key areas that need to be addressed in order for the capital market to deliver on long-termism and sustainability. These are:

- Investor advocacy influence
 - (a.) Sustainability or CSR report should be put to a vote at a company’s AGM on a comply or explain basis.
 - (b.) Policy-makers should establish mechanisms that promote, encourage and require investors to maintain appropriate oversight role of companies; for example, investors could be required to publicly disclose their voting record and pension trustees to report to their beneficiaries on how their ownership rights have been exercised.
 - (c.) Regulatory enforcement measures of the Stewardship Code.

²⁹ “Going Concern and Liquidity Risks: Lessons for Companies and Auditors—Preliminary Report and Recommendations of the panel of Inquiry” (2011) The Sharman Inquiry

³⁰ <http://www.guardian.co.uk/sustainable-business/aviva-chief-city-failure-sustainability>

³¹ See for example “Employment Risk, Compensation Incentives and Managerial Risk taking—Evidence from the Mutual Fund Industry” (2007) Kempf et al.

³² See Professional Pensions, 15 December 2010

³³ See for example “The Selection and Termination of Investment Management Firms by Plan Sponsors” (2008) Goyal and Wahal

- (d.) Regulation and improved accountability of voting agencies.
- Incentives of all players in the capital markets
 - (a.) Fund manager performance should be reviewed over longer time horizons than the typical quarterly cycle.
 - (b.) Excessive reliance on measuring performance relative to a market index should be reduced.
 - (c.) Pension funds should have voting and engagement policies that should be integrated into the investment process.
 - (d.) Shareowner activism should be given more weight in the selection and retention of fund managers and other matters.
 - (e.) Implementation of strong cultural norms supported by independent whistleblowing mechanisms, overseen by professional bodies who offer the whistleblower appropriate protection.
 - (f.) All advisors to institutional investors should have a duty to proactively raise ESG issues and encourage adherence to the Stewardship Code.
 - (g.) Fund management contracts and fund managers' performance should include an evaluation of long-term ability to beat benchmarks.
 - (h.) Investment consultants' fee structures should not reward them for moving clients between fund managers.
- Availability of market information
 - (a.) Policy-makers could clarify that long term investment research that is orientated towards good stewardship behaviour by investors can be paid for in this way.
 - (b.) Policy-makers could suggest as a guide that it is good practice for a material proportion of the commission research (say 10–25%) to be spent in this way.
 - (c.) Policy-makers could say that it is good practice for fund managers to be transparent to their clients that this was taking place.
 - (d.) Policy-makers could say that it is good practice for clients to be allowed to opt out of this, as long as they are clear to their beneficial owners what their rationale is for so doing.
 - (e.) Disclosure from investors and their agents on integration of ESG issues into the investment process.
 - (f.) Integrated narrative reporting should be required from all listed companies on a comply or explain basis.
- Training and education
 - (a.) Fund manager and analyst training centres eg the Chartered Financial Analyst Institute should use their syllabus and charterholder exam to look at how sustainable development work of companies may enhance corporate valuation.

Steve Waygood
Chief Responsible Investment Officer, Aviva Investors
17 January 2013

Supplementary written evidence submitted by Aviva plc

FINANCING LONG-TERM INVESTMENT RESEARCH

A proposal to increase investor stewardship

Among the most significant capital market failures is the failure of investors to be long term in their investment analysis and then behave as responsible owners—or stewards—of listed companies.

This lack of long term stewardship has been identified as an economic problem by successive Government reviews [Cadbury (1991); Hampel (1998); Walker (2009); Kay (2011)]. It is also considered by many experts to have been a significant contributory factor to the financial crisis (Walker, 2009).

The specific market failure is that responsible ownership is a non-excludable public good, ie the benefits of engagement are enjoyed by all owners regardless of whether they behave as responsible long term owners. Consequently, the vast majority of profit maximising commercial fund management institutions free ride and either do not do stewardship at all, or invest only token resources in this work.

Stewardship is under-funded and arguably profoundly so. We estimate that the average budget of a FTSE 100 company for compliance with the Corporate Governance Code is c. £5million per annum in comparison with the average budget of the top 100 fund managers on Stewardship, which is in the order of £120k.

This is not a discussion of equals. How can investors support leading companies that conduct thorough stewardship, or—perhaps more importantly—challenge the laggards, when the resources that they invest in this area are practically insignificant?

As noted, there has been considerable work in this area, yet Professor Kay's recent Review of Equity Markets and long-term decision making surprisingly does not consider how to significantly increase either the economic demand for, or the financial funding of stewardship. In general, it is assumed that fund managers will be responsible and accept their public interest role for them to conduct stewardship and voluntarily invest more in their stewardship work. This is misguided at best and economically naive at worst. Unfortunately, without demand from beneficiaries and a financial funding solution, the scale of investment stewardship will be piecemeal and disproportionately low. Investor stewardship makes financial sense for fund managers as it improves the long-term health of their funds but they are not currently equipped with the research that will allow them to pursue long-term investment strategies.

Fortunately, as Professor Kay recognises, there is no shortage of money in the system for financing the work of the various market intermediaries. Equity commissions are attached to every trade, which despite belonging to the asset manager's client are spent by the asset manager. Most equity commissions are split into two parts: execution (for the physical cost of trading and executing the transaction) and non-execution (for all other services including investment research). The latter can be used to buy research from any type of provider and this global research spend amounts to \$22 billion per year (Source: Frost Consulting, July 2012).

A few fund managers—including Aviva Investors—are directing this research commission towards brokers and independent research providers of long term investment research, voting advice and stewardship work. We are clear that such investment in stewardship adds value to investment decisions and is in the long term interests of our clients. However, this approach remains uncommon and those fund managers that do utilise this mechanism tend to spend only a few percentage points of their research commission in this way.

We believe that if the FCA were to take the following four steps, then it would significantly increase the scale of stewardship resources in the market and fundamentally transform the delivery of long term investment analysis and investor stewardship:

1. The FCA could clarify that long term investment research that is orientated towards good stewardship behaviour by investors can be paid for in this way.
2. The FCA could suggest as a guide that it is good practice for a material proportion of the commission research (say 10–25%) to be spent in this way.
3. The FCA could say that it is good practice for fund managers to be transparent to their clients that this was taking place.
4. The FCA could say that it is good practice for clients to be allowed to opt out of this, as long as they are clear to their beneficial owners what their rationale is for so doing.

This would have the following benefits:

- The market for stewardship would be transformed with materially more resources flowing into this work.
- Companies would benefit from engaged, informed and responsible owners raising any concerns at an early point without the need to use the press to highlight their issue.
- The end owners of the assets and, therefore, the beneficiaries of the stewardship work, would be financing the stewardship on their assets through their trading commission.
- The government would be creating an enabling environment for responsible capitalism at no cost to the exchequer and with no long term regulatory burden.

*Steve Waygood
Chief Responsible Investment Officer
Aviva Investors
18 March 2013*

Written evidence submitted by FairPensions

SUMMARY

- The Kay Review correctly concludes that there is a mismatch between the long-term interests of savers such as pension funds and the short-term incentives of the investment intermediaries managing their money.
- Ways of addressing this misalignment include legal mechanisms (ie fiduciary duties), financial mechanisms (ie remuneration design) and market mechanisms (ie consumer pressure & accountability). The Kay Review makes strong proposals on the first two of these three, but has less to say about the third. This is an area which would benefit from further policy intervention, for example to strengthen savers' rights to information about their investments.

- We strongly welcome the Kay Review’s proposals on investors’ fiduciary obligations:
 - Clarification of *what* these duties mean—in particular, that they do not oblige fiduciary investors to maximise short-term profits at any cost—is overdue. We support the decision to refer this matter to the Law Commission, which we hope and expect will be empowered to recommend statutory clarification.
 - Kay is right to argue that fiduciary standards of care should apply to all those managing other people’s money. We are pleased that the government accepts this in principle, but have some concerns that the wording of its revised Good Practice Statements may inadvertently water down the standards to be applied.
- The Stewardship Code is an important vehicle for promoting long-term, responsible ownership by institutional investors. It has so far been very successful in gaining acceptance by the investment industry, but less successful in generating demonstrable behaviour change. We believe its potential could be enhanced by:
 - strengthening the Code in a number of areas, eg management of conflicts of interest, attention to systemic risk, and emphasis on factors beyond financial results;
 - providing for independent monitoring of adherence to the Code’s principles, to be reported to parliament annually; and
 - building the capacity of pension funds and underlying pension savers to hold their investment agents to account for their stewardship activity.
- We agree with Kay that “high quality, succinct narrative reporting” is an important tool to enable investors to engage on issues of long-term strategy. We are concerned that the government’s current proposals are unlikely to make any significant difference to the quality of reporting.

ABOUT FAIR PENSIONS

1. FairPensions is a registered charity that works to promote active share-ownership by institutional investors in the interests of their beneficiaries and of society as a whole. Our particular focus is on encouraging shareholder engagement with listed companies to ensure effective management of environmental, social and corporate governance (ESG) risks which may affect long-term financial returns.

2. We are a member organisation. Our members include bodies representing pension savers, leading UK charities and thousands of individual pension fund members. We are independent of industry and are funded primarily by grants from charitable foundations and trusts.

3. Fair Pensions has been closely involved with the Kay Review from its inception through to the government’s response. In particular, our research on institutional investors’ fiduciary duties has been influential in shaping the Review’s recommendations. Accordingly our evidence focuses on the Review’s recommendations regarding fiduciary duty, although we also comment on other areas which fall within our expertise.

INTRODUCTION: ANALYSIS OF THE PROBLEM OF SHORT-TERMISM

4. We agree with the Kay Review’s analysis that resolving the problem of short-termism is not simply a matter of enhancing the influence of “long-term” investors (such as pension funds) and stemming the rise of “short-term” investors (such as high frequency traders). Rather, there are underlying structural problems with equity markets which cause theoretically long-term investors to behave in a short-term way.

5. Likewise, we agree that promoting more effective “stewardship” of companies by investors is not simply a matter of encouraging more shareholder engagement. For instance, in the run-up to the financial crisis, shareholder engagement with major financial institutions was not simply insufficient but actively damaging. Increased leverage and short-termist business models were often justified in the name of shareholder value, and (as far as we can ascertain) only one major asset manager voted against the takeover of ABN-AMRO by RBS.

6. In the recent FRC review of the Stewardship Code, many companies felt that “*some shareholders still seemed to focus too much on specific issues of a short-term nature*”.³⁴ Similarly, in a survey of ten large European pension funds, the funds estimated their ideal time horizon at 23 years and their actual time horizon at six years.³⁵ There is clearly a misalignment between the inherently long-term financial interests of pension savers and the often short-term outlooks of those managing their money.

³⁴ FRC, December 2011, ‘Developments in Corporate Governance 2011: The impact and implementation of the UK Corporate Governance and Stewardship Codes’. Available at <http://www.frc.org.uk/images/uploaded/documents/Developments%20in%20Corporate%20Governance%2020116.pdf>

³⁵ Hesse, 2008, ‘Long-term and sustainable pension investments: A study of leading European pension funds’. See <http://bit.ly/uaPQdd>

7. There are three complementary mechanisms for addressing this “principal/agent” problem:

- Legal mechanisms: ensuring that all those managing other people’s money have fiduciary duties to act in their best interests, and that these duties are understood in a way which promotes those interests over the long-term.
- Remuneration: ensuring that the pay of investment intermediaries is structured in a way which aligns with the long-term interests of beneficiaries and does not create perverse incentives to focus exclusively on short-term share price movements.
- Consumer pressure: forging a stronger link between investment institutions and underlying savers, so that those with a real interest in long-term performance are able to hold their agents to account directly. This parallels the government’s approach to executive pay, which has focussed on giving shareholders the tools to hold managers to account.

8. In our view, the Kay Review’s recommendations are strong on the first two of these three levers: we particularly welcome moves towards clarification of institutional investors’ fiduciary duties. The Review has less to say about the third lever; this is an area which would benefit from further policy thinking.

1. FIDUCIARY DUTIES

a. *Clarifying the content of fiduciary duties (Recommendation 9)*

9. We welcome the Kay Review’s recommendation for a Law Commission review of the application of fiduciary duties to investment. Pension fund trustees have a fiduciary duty to act in the best interests of their beneficiaries. (The extent to which similar duties apply to other investment intermediaries is discussed below.) This duty should be part of the solution to short-termism in equity markets, but it has too often been part of the problem.

The problem

10. Fiduciary investors tend to assume that their legal duties begin and end with maximising returns, and this in turn tends to be interpreted in terms of short-term returns relative to a benchmark. In our experience, this contributes to an excessive focus on short-term share price movements and to the neglect of factors which are not easily monetisable, including:

- environmental, social and governance (ESG) factors with implications for companies’ long-term financial value;
- systemic risks (be it risky lending in the financial sector or the implications of climate change) with potential financial impacts that far outweigh the effects of individual funds’ relative performance; and
- non-financial factors, such as beneficiaries’ ethical views or the implications of investments for their quality of life or community.

11. Some examples of this problem from our own experience include:

- One large UK pension scheme was given legal advice suggesting that their policy of exercising voting rights could breach their fiduciary duties if they could not demonstrate that the costs incurred were justified by monetisable benefits to that individual scheme. Since the benefits of stewardship almost inevitably accrue to the market as a whole, this contributes to a “free-rider” problem which holds back the shift towards a stewardship culture.
- We are aware of fund managers who lost contracts in the 1990s because they saw the “dotcom bubble” for what it was and refused to invest in tech stocks. Although with hindsight this was clearly a prudent long-term strategy, it led such managers to underperform their peers in the short-term. Many pension funds assumed they would be failing in their fiduciary duties if they did not respond to this by hiring a more orthodox manager. It is not unreasonable to suppose that some funds may have suffered loss as a result.
- One officer of a multi-employer pension fund recounts seeking legal advice on whether, when voting on a hostile takeover, they could take account of the fact that some of their beneficiaries might lose their jobs. The response was that this was not a relevant consideration: the trustees’ fiduciary duty bound them only to consider the price they would be paid for their shares.

Response to the Kay Review’s proposed solution

12. Fair Pensions has advocated statutory clarification to confirm that institutional investors *may* have regard to a wider range of factors than is commonly assumed. We have produced draft legislation illustrating how this could be done, modelled on section 172 of the Companies Act 2006 which sought to achieve a similar objective in relation to company directors. The Kay Review agreed that there is “*a need to clarify how these duties*

should be applied in the context of investment, given the widespread concerns about how these standards are interpreted”, but proposed that the matter be referred to the Law Commission. We support this course of action, provided that:

- the review is conducted in a timely manner, with steps taken to minimise any “chilling effect” on investor behaviour in the meantime (for instance, by reiterating and publicising the government’s view that the law does allow wider scope for discretion than is often assumed); and
- the Law Commission is empowered to recommend statutory clarification if it concludes that this is necessary, with a clear presumption in favour of speedy implementation of any legislative proposal.

13. In our experience, narrow interpretations of the law are reinforced by cautious legal advice, perpetuated by a lack of relevant case law, rather than simply being the result of trustee misunderstandings. We find it difficult to see how this problem will be resolved without express clarification of the law.

b. Clarifying the scope of fiduciary duties (Recommendation 7)

14. Kay also argues that short-termism is related to the replacement of relationships based on trust and confidence with a “transactional” trading-led culture, and that reasserting fiduciary standards will help to refocus equity markets on the long-term interests of savers rather than those of financial intermediaries. We agree that all those managing other people’s money should be held to fiduciary standards of care, and that—combined with action to address misinterpretations of fiduciary duty, as discussed above—this should help to promote long-termism.

The problem

15. Fiduciary duties exist to ensure that those acting on behalf of others keep their best interests at heart. Yet there remains some confusion about who fiduciary duties apply to. While it is clear that pension fund trustees are fiduciaries, the status of many others who look after savers’ money is less clear-cut:

- There appears to be a growing consensus that asset managers are subject to fiduciary duties: the Law Commission has concluded that “*in general a firm advising a customer or making purchases on a customer’s behalf will be acting in a fiduciary capacity.*”³⁶ However, this is still not undisputed, and asset managers often use the term “fiduciary” to describe a general duty of care towards clients rather than to indicate acceptance of the strict obligation to put beneficiaries’ interests first.
- Insurance companies (who are responsible for an increasing proportion of the nation’s pension savings) are generally held not to have fiduciary duties. This is largely because individuals saving with an insurance company are not the “beneficial owners” of the assets invested: instead the assets are owned by the insurance company, with the saver’s rights over them arising from their contract with that company. However, the economic relationship is essentially the same: one person is still entrusting their money to another for investment purposes.

16. It has been argued that debates about the extent of fiduciary duties are a legalistic irrelevance, since FSA rules (including those stemming from European regulations such as MiFID) already require investment intermediaries to act in the best interests of their clients. This is misleading. As the Law Commission has observed, “*there are many instances where regulatory rules permit... a lower standard of conduct than that required by fiduciary law.*”³⁷ For example, fiduciary duties require “*single-minded loyalty*” to beneficiaries,³⁸ while FSA rules merely require that firms pay “*due regard*” to the interests of their customers. Similarly, fiduciaries are required to avoid conflicts of interest wherever possible, and where impossible, to ensure that they are always resolved in the interests of the beneficiary. FSA rules require only that “*a firm must manage conflicts of interest fairly*”. Balancing the interests of consumers with the interests of the firm is a very different proposition from single-mindedly putting consumers’ interests first.

17. In our view, these legal differences do indeed have practical implications. There is considerable anecdotal evidence that conflicts of interest among fund managers are a barrier to more robust shareholder engagement. For example, one recent paper cites an instance where “*the company secretary of a UK manufacturer reminded a fund manager who was intending to vote against the company’s remuneration report that his firm was bidding for an investment mandate from the corporation’s pension plan*”.³⁹ In financial conglomerates, conflicts may also arise between asset management arms and investment banking arms.

18. When we surveyed asset managers’ disclosures under the Stewardship Code, we found that many gave little or no insight into how conflicts were managed.⁴⁰ To take a specific example, in the recent “Shareholder

³⁶ Law Commission, 1992, ‘Consultation Paper No. 124: Fiduciary Duties and Regulatory Rules’ (HMSO), para 2.47

³⁷ Law Commission, 1995, ‘*Fiduciary Duties and Regulatory Rules*’, (HMSO), para 1.8

³⁸ Bristol and West Building Society v Mothew [1996] 4 All ER 698

³⁹ Wong, S., ‘How conflicts of interest thwart institutional investor stewardship’, Butterworths Journal of International Banking and Financial Law, Sept 2011

⁴⁰ FairPensions, 2010, ‘Stewardship in the Spotlight’, p9, http://www.fairpensions.org.uk/sites/default/files/uploaded_files/whatwedo/StewardshipintheSpotlightReport.pdf

Spring”, both Aviva and Prudential suffered high profile rebellions on pay. Aviva Investors’ conflicts of interest policy sets out clear procedures for when and how it will vote shares in Aviva plc.⁴¹ M&G (the asset management arm of Prudential) has no such policy. In accordance with its policy, Aviva Investors did not vote on Aviva plc’s remuneration report unless in accordance with explicit instructions from clients. M&G voted in favour of Prudential’s controversial remuneration report; its voting disclosures provide no explanation of this decision or of how this conflict of interest was managed. The FRC and FSA⁴² have also identified conflicts as an area for improvement.

Response to the Kay Review’s proposed solution

19. The Kay Review recommended that “*regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions*”. Whilst accepting the thrust of Kay’s recommendation, the government’s response stated that it has “*elected to avoid using the word ‘fiduciary’*”, citing confusion over the scope of the term. In our view, the prevalence of conflicting assumptions about the scope of fiduciary obligation is precisely why this area of the law ought to be clarified.

20. However, even if the government chooses not to explicitly use the word “fiduciary”, the most important thing is that the standards of care which it promotes are equivalent to fiduciary standards. In our view, the wording of the government response creates—presumably unintentional—ambiguity on this front. The revised “good practice statement” does not explicitly assert the duty of undivided loyalty to clients/beneficiaries, stating only that “*conflicts of interest [should be] avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary.*” This would seem to imply that merely disclosing the existence of a conflict of interest is equivalent to managing that conflict in accordance with beneficiaries’ interests. In our view, this is not the case and does not tally with fiduciary standards.

21. We are very pleased that the government has asked the FSA/FCA to assess the extent to which its rules align with the “fiduciary-like” principles it has outlined. However, we are concerned that the wording of those principles must be clarified and refined, since the current wording obscures the very issue (ie conflicts of interest) where the difference between FSA rules and fiduciary duties is most significant. If this is not addressed, any FSA/FCA review could miss an important opportunity to meaningfully raise standards of consumer protection.

2. THE STEWARDSHIP CODE

22. The Kay Review recommends that “the Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance”. We agree that the Stewardship Code is an important vehicle for promoting investor long-termism, but have always regarded its principles as relevant to company strategy as well as corporate governance. Nonetheless, we believe there are other ways in which the Code could be improved, as outlined in our response to the FRC’s recent consultation.⁴³ Accordingly, although we accept the government’s view that this consultation has addressed Kay’s specific recommendation, we do not think that this should mark the end of policymakers’ engagement with the Code.

23. In particular, FairPensions has argued that the Code should:

- articulate more explicitly that engagement can and should extend beyond immediate financial matters and encompass drivers of a company’s long-term fundamental value, including environmental, social and governance (ESG) factors. This would help to address complaints from company directors that shareholder engagement is still short-term in nature and focussed too heavily on quarterly financial results;
- address more explicitly the role of institutional investors, particularly “universal owners” such as pension funds with holdings across the economy, in nurturing the wider economy and attending to potential systemic risks, rather than only engaging with risks to individual companies in their portfolio. Such systemic factors have far greater implications for returns to beneficiaries than the performance of any single company,⁴⁴ but this is not yet reflected in the way investors engage. The Stewardship Code could play a vital role in catalysing this cultural shift and overcoming the collective action problems which hold back engagement on systemic issues;
- be stronger and clearer in respect of conflicts of interest. As discussed above, our research finds this to be a consistent area of weakness amongst asset managers. The recent amendments to the Code, although welcome, do not seek to ensure that signatories explain how key conflicts of interest are managed in practice; and

⁴¹ http://www.avivainvestors.com/internet/groups/internet/documents/salessupportmaterial/pdf_024453.pdf

⁴² <http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf>

⁴³ See http://www.fairpensions.org.uk/sites/default/files/uploaded_files/StewardshipCodeReview2012.pdf

⁴⁴ See for example Brinson et al, 1991, “*Determinants of Portfolio Performance II: An Update*”, Financial Analysts Journal vol 47, no. 3 (May/June): 40–48; Ibbotson, “*The Importance of Asset Allocatio*”, Financial Analysts Journal Vol 66 No 2 (March/April 2010)

- articulate a clearer definition of “stewardship”. Although steps have been taken in the most recent version of the Code to address this ambiguity, the Code still does not define the term “stewardship” as such. In our experience, there is still confusion over what is being “stewarded” (companies, savers’ assets, or the economy and environment on which financial returns depend) and to whom stewardship obligations are owed (companies or savers).

24. We have also argued that the IMA’s annual survey is not the appropriate vehicle for official monitoring of the Code’s implementation, and that either the FRC itself or an independent academic institution should be resourced to undertake an independent annual survey. The FRC could also be required to report regularly to BIS on the Code’s implementation, with such reports being laid before parliament. In our experience, the Stewardship Code has so far been commendably successful at gaining the support of the investment industry, but it is far from clear that this support is translating into changed behaviour in practice. Effective, independent monitoring of whether progress is being made in this regard, made available to government and parliament, is an essential tool for policymakers to judge whether additional measures are needed.

25. Finally, policymakers must ensure that clients and beneficiaries are empowered to scrutinise the stewardship approaches of those who manage their money. This is essential if “comply or explain” is to be effective, since it relies on bottom-up scrutiny as a substitute for detailed top-down regulation. For example, instead of listed companies’ compliance with the Corporate Governance Code being enforced by regulators, it is overseen from below by shareholders (although the extent to which this actually takes place appears to be variable⁴⁵). The parallel audiences for disclosures under the Stewardship Code are clients and beneficiaries: pension funds in the case of asset managers, and underlying savers in the case of pension funds themselves. But structural problems hold back effective scrutiny:

- Pension funds have so far been less keen than asset managers to engage with the stewardship agenda, with many not seeing it as a priority, and some even believing (as we have seen) that it falls outside the scope of their legal mandate. Clarification of fiduciary duties should help to address this.
- Individual savers are disconnected and disempowered: lack of understanding and an endemic lack of transparency and accountability makes it difficult for them to engage with what happens to their money. Policymakers should take steps to improve public disclosure (for instance, of voting records) and strengthen beneficiaries’ rights to receive more detailed information on request.

3. THE INVESTOR FORUM

26. Collective engagement is vital given the increasing dispersion of ownership. In addition, effective collective action should enable investors to engage with wider systemic challenges affecting returns across their portfolio (such as climate change), as well as engaging on strategy at individual companies.

27. It remains to be seen whether the establishment of an “investor forum” as recommended by Kay will lead to a step change in this activity. At first sight it is unclear how this initiative will differ from previous and existing investor bodies, such as the Institutional Shareholders Committee (ISC).

28. Kay correctly identifies that misaligned incentives running through the system help to perpetuate short-termism. It is therefore somewhat surprising that his recommendations largely expect change to come from within that system (that is, through voluntary action from investment professionals, and asset managers in particular). In our view, it follows logically from Kay’s analysis of the problem that some kind of external force must act on the system in order to shift the incentives of its participants onto a more long-termist, sustainable footing. This would seem to be a prerequisite for effective industry action on the scale Kay wishes to see.

29. Such external action can come either from above (ie regulators) or below (ie clients and beneficiaries) or a combination of the two. However, experience suggests that at least one of these will be necessary: it will not be sufficient simply to expect the system to heal itself. Our recent report, *“The Missing Link: Lessons from the Shareholder Spring”*, provides further evidence of the disconnect between underlying savers and those who manage their money, and argues that policymakers should address this. Copies of this report have been provided to members of the Committee.

4. NARRATIVE REPORTING

30. Robust, meaningful company reporting on factors affecting the long-term value of a business—including environmental and social factors—is a prerequisite for effective investor engagement on these issues. The 2010 Coalition Agreement included a commitment to *“reinstate an Operating and Financial Review to ensure that directors’ social and environmental duties have to be covered in company reporting”*. This commitment originated in the Liberal Democrat Manifesto.

31. The key difference between the Operating and Financial Review (OFR) and the current Business Review was that the OFR required a higher standard of assurance (the “enhanced audit”). It was our understanding that

⁴⁵ See for example Arcot, Bruno & Grimaud, 2005, “Corporate Governance in the UK: Is the comply-or-explain approach working?”

the coalition commitment reflected this key difference and that its intent was to ensure that companies produced narrative information which investors could rely on. We strongly welcomed this commitment, since anecdotally we hear that one reason investors do not heed such information is that it lacks rigour and verifiability.

32. However, it soon became clear that (apparently as a result of the government’s policy of “one-in, one-out regulation”) there was little appetite for including enhanced audit standards in the new narrative reporting framework. Instead, the Business Review is to be replaced with a new “Strategic Report” whose status and prescribed content is almost identical to that of the Business Review, except for a renewed emphasis on strategy for quoted companies. This is to be supplemented with an “Annual Directors’ Statement”, although it is unclear whether this will be prescribed by regulation, and if so what its content will be.

33. In our view this package of reforms to narrative reporting does not meet the spirit of the coalition commitment. It contains nothing which we would expect to drive up the quality of social and environmental reporting—the key objective of the original commitment. We are also sceptical of the contribution it will make to Professor Kay’s recommendation that “*high quality, succinct*” narrative reporting should be strongly encouraged—not least because it has little to say about what constitutes “high quality” reporting. We understand that the FRC will shortly be consulting on revised guidance for companies preparing narrative reports. This may provide an opportunity to rectify this disappointing outcome.

18 January 2013

**Supplementary written evidence submitted by ShareAction
(formerly FairPensions)**

Thank you very much for the opportunity to give oral evidence to the Committee’s inquiry on the Kay Review of UK Equity Markets. I am writing to clarify some aspects of our oral evidence, and to let you know of a change to FairPensions’ operating name.

Firstly, as of Monday 18 March, FairPensions will become ShareAction. This reflects the broader scope and relevance of our work to promote responsible and engaged share-ownership. It is also intended to clarify that our focus is on invested pension savings (and the investment system more generally) rather than on the state pension or on unfunded public sector schemes, as is often assumed. We have been in touch with Committee officials regarding the implications of this change in the event that we should be cited by name in the Committee’s final report.

As you are aware from our written and oral evidence, our two key areas of expertise and interest are fiduciary duty and accountability to underlying savers. The below is intended to summarise and clarify our position on these two issues.

FIDUCIARY DUTY

As you know, Professor Kay made two separate recommendations about fiduciary duty. The first concerned the question of *who* has fiduciary duties: Professor Kay recommended that these standards be extended to all those managing other people’s money. The second concerned the question of *what* these fiduciary duties mean, and in particular the need to clarify that they do not oblige institutional investors to focus solely on short-term share price movements: Professor Kay recommended that this be referred to the Law Commission.

The first of these two recommendations was well covered in the oral evidence session, but discussion of the second was somewhat truncated due to lack of time. We therefore thought it might be helpful to briefly restate our position, and in particular to clarify our perspective on the relationship between directors’ duties under the Companies Act and our proposed clarification of investors’ duties.

Section 172 of the Companies Act 2006 was designed to correct the widely held misconception that directors’ duty to act in shareholders’ interests prevented them from taking a long-term view and from considering their social and environmental impacts. It clarified that directors should “have regard” to these wider factors as part of their duty to promote the success of the company. This exactly mirrors the problem with interpretations of investors’ duties which we and Professor Kay have highlighted: there is a widely held view that institutional investors’ duty to act in the interests of underlying savers prevents them from taking a long-term, enlightened approach to the companies in which they invest.

Our argument is that these two problems are intrinsically connected. The Companies Act sought to achieve long-term, responsible corporate behaviour by promoting “enlightened shareholder value” (rather than by extending rights to other stakeholders in the company). But this job remains unfinished as long as major shareholders continue to believe that they themselves are legally obliged to be unenlightened.

This may help to explain the seemingly limited impact of the changes to directors’ duties under section 172.⁴⁶ Surveys suggest that directors continue to feel they have limited room for manoeuvre, particularly in hostile takeover situations, where it is assumed that the directors’ duty to get the best price for shareholders

⁴⁶ See for example Collison et al, 2011, “Shareholder Primacy in UK Corporate Law: An Analysis of the Rationale and Evidence”, ACCA

“trumps” section 172. If major shareholders interpret their own duties in terms of the maximisation of short-term return, it is hardly surprising that this imperative will be transmitted up the chain to directors. This fits with the evidence (both anecdotal and empirical) from directors about why they make the decisions they do.⁴⁷

It is for this reason that we believe explicit clarification of investors’ fiduciary duties, mirroring the clarification of directors’ duties offered by section 172 of the Companies Act, is an important part of the solution to short-term pressures on companies. We very much hope that this will be the outcome of the Law Commission’s review.

The above is elaborated in our 2012 report “The Enlightened Shareholder”, a copy of which is enclosed. We would be pleased to provide additional copies to the Committee if necessary.

TRANSPARENCY AND ACCOUNTABILITY

As you know, we believe that in order to make Professor Kay’s vision for equity markets a reality, it will be necessary to strengthen the connection between savers and their money, by enhancing transparency and accountability of the investment industry to its customers. In our view, insufficient thought has been given to this by policymakers, who have tended to focus instead on the connection between companies and institutional investors. We have recently embarked on a research project aimed at rectifying this imbalance, which will be reporting with policy recommendations in the summer. Meanwhile, mindful of your request for specific proposals, we thought it might be helpful to summarise our key suggestions to date.

- Pension funds should be obliged to report to their beneficiaries not just on their investment and voting policies (as now), but also on how those policies have been implemented on an annual basis. This could take the form of a “narrative report” along similar lines to the reports which companies are obliged to produce for their shareholders.
- Government should exercise its reserve power to introduce mandatory voting disclosure for institutional investors. Please see below for more detail on the case for this measure.
- Institutional investors could be obliged to hold annual meetings (in the same way that companies must hold annual meetings for their shareholders) offering savers the opportunity to hold their fiduciaries to account.
- Government could explore ways to support and strengthen the role of member-nominated trustees, and to extend similar member representation to contract-based forms of pension provision. We could also learn from the approach taken in other jurisdictions, for example Denmark’s system of “member delegates”, which provides an additional level of scrutiny between the pension fund and the membership at large.

The case for mandatory voting disclosure

Disclosure of information about voting and engagement allows underlying savers to hold their agents to account for the exercise of shareholder rights on their behalf. ShareAction (FairPensions) works to build such a culture of accountability, and at present we find that lack of transparency is a fundamental barrier to its development. Individuals who contact their pension funds to ask how votes were cast at a particular company or on a particular issue are often given no information or simply told that the decision is delegated to asset managers.

We recently conducted an analysis of responses to saver emails about voting intentions on executive pay, sent via an email tool we built in April 2012. Less than half of responses stated that the fund disclosed their voting records, and only around one in five provided direct links to such disclosures.⁴⁸ This is a disheartening experience for savers who are therefore less likely to continue attempting to engage with decisions about their money. Improved transparency has the potential to transform this “vicious circle” into a “virtuous circle” of greater engagement and accountability.

Our benchmarking surveys of institutional investors consistently find a link between transparency and substance: in other words, investors who disclose good information about their policies and practices tend to perform better in our analyses of the quality of their policies and their evidence of commitment to stewardship.

Voluntary mechanisms (such as the Stewardship Code) have generated improvements in voting disclosure, but evidence suggests that these improvements are beginning to plateau, at a level still far below universal disclosure. Although the IMA suggests that around three-quarters of Code signatories now disclose some voting information, this figure includes summary statistics (ie the total number of votes cast for and against management in a given year) which we would not regard as meaningful voting disclosure. Research by PIRC suggests that, even among Stewardship Code signatories, the proportion disclosing full information about individual votes cast is in fact just 21%.⁴⁹ This reinforces the case for mandatory requirements which clearly set out the information to be provided in order to ensure that it is comprehensive and comparable.

⁴⁷ See for example Graham et al, 2004, “The Economic Implications of Corporate Financial Reporting” (in a US context)

⁴⁸ FairPensions, 2012, “The Missing Link”

⁴⁹ See <http://www.pirc.co.uk/news/voting-disclosure-revisited>

Practical arguments sometimes made against mandatory public disclosure of voting include:

- that it would impose an unreasonable cost on investors;
- that it would breach commercial confidentiality; and
- that it would be pointless as there is no demand for this information.

In our view these arguments have little merit:

- The vast majority of UK investors already record data about their voting behaviour. The cost of disclosure is simply a matter of formatting this data and uploading it to a public website. Evidence from investors who already do this suggests that these costs are minimal.
- We see no reason why voting information should be commercially sensitive. The fact that many investors disclose their voting records (usually quarterly in arrears) suggests that these concerns are unfounded.
- As indicated above, the opacity of the investment system is itself a key barrier to the development of demand for this information. In any case, the information will be used by academics and civil society organisations (such as ourselves) to compare investors against each other in a more consumer-friendly format. Finally, the knowledge that voting decisions are subject to public scrutiny may in itself help to shift behaviour.

Catherine Howarth

Chief Executive, ShareAction (formerly FairPensions)

14 March 2013

Written evidence submitted by the Association of General Counsel and Company Secretaries of the FTSE 100 (GC100)

This submission is on behalf of the Association of General Counsel and Company Secretaries in the FTSE 100, generally known as the GC100. There are currently 131 members of the group, representing more than 82 companies.

The GC100 is grateful for the opportunity to respond to the call for evidence referred to above. Our response on the matters on which you are seeking views is set out below. Please note, as a matter of formality, that the views expressed in this letter do not necessarily reflect those of each and every individual member of the GC100 or their employing companies.

1. Executive Summary

We broadly support the Kay Review and the Government's response as an overarching framework of aspirations for how the UK equity markets should operate. Likewise, we believe that the general principles are, in the main, useful high level statements of best practice. The key challenge will be how these concepts are understood and implemented within the complex legal and regulatory matrices in which the UK equity markets operate. This will require careful and detailed examination and discussion.

In addition to the domestic framework, the UK equity markets are subject to regulation at the European and international level. This is particularly the case for the significant number of companies with dual or multiple listings. These, and many other UK companies whose only listing is in London, have businesses and teams located in and/or recruited from other jurisdictions. Their businesses and management (including board) recruitment and retention arrangements are therefore structured and run to reflect both UK and international demands. Furthermore, the importance of international investment in London-listed companies means that the UK market is inextricably linked to the commercial and governance requirements and expectations of market participants in other jurisdictions. Although we believe that many of the recommendations in the Kay Review and the Government's response are commendable, it is imperative that any specific proposals flowing from the Kay Review be formulated and implemented in this context.

In particular, care needs to be taken to ensure that UK companies:

- are able to compete effectively with their peers in other jurisdictions;
- are not subject to requirements which deter international investment; and
- can recruit and retain the best management teams, including directors, for their companies and businesses.

2. DETAILED SUBMISSION

2.1 *Directions for Market Participants—paragraph 3*

Paragraph 3 of the Directions for Market Participants recommends that there should be more opportunity for collective action by asset managers who should have more freedom to act collectively without fear of regulatory consequences. We agree with this, and in particular, the need for people to be able to collaborate without fear of being deemed to be acting in concert under the UK Takeover Code. However, we believe that the Takeover

Code, as interpreted in light of Practice Statement 26, already confers on asset managers the necessary freedom to take collective action and that they do not need any greater regulatory exemptions or dispensations to facilitate this.

2.2 Recommendation 1: The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.

We support this Recommendation and believe that discussion and debate on remuneration and other governance issues is far more productive when placed in the context of a company's long-term strategy rather than, as so often appears to be the case, being conducted in isolation. Some of our members have reported that where a broader view is taken, for example, where fund managers and corporate governance or remuneration analysts are both represented at the same meetings, this can be more productive than meetings which are attended only by those responsible for corporate governance.

2.3 Recommendation 2: Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements.

We support this Recommendation in principle.

Please also see our specific comments on Annex A—Good Practice Statement for Directors, at paragraph 2.14 below.

2.4 Recommendation 3: An investors' forum should be established to facilitate collective engagement by investors in UK companies.

We would express a cautious interest in the concept of investors' forums. There is, of course, nothing to prevent interested parties from establishing such forums now, which leads us to question whether there is really a need for this type of body—if there is, would they not already be widely in existence?

If investors felt that such a body would help them to engage more effectively with investee companies, then we think that this proposal should be pursued but a number of aspects would warrant further development as noted below.

We assume that the plan would be for a specific forum to be created for an individual company, as we do not think that it would be workable for a forum to cover multiple companies. The success of such a forum would depend on its having well defined parameters (objectives, attendees, frequency etc), yet retaining the flexibility to meet the circumstances of individual companies. For such a forum to add value there would need to be a commitment to candid discussion.

The composition of the forum would be very important. Whilst the idea is termed an "investors' forum" we would not wish such forums to comprise solely of investors who set the agenda and provide the company with their views. It would have to be a collaborative exercise with the company being properly represented and conduct of the meeting being effectively regulated. We would also be interested in understanding more about the criteria that would be recommended to ascertain which investors could attend—would it, for example, be based on a qualifying percentage of share ownership or open to any shareholder? How would significant shareholders based overseas be encouraged to participate? It will be key to ensure that the eligibility criteria for participation in the forum (and any guidelines as to how the forum operates) are such that stability and consistency are promoted. For engagement to be meaningful over the longer-term, the forum will need to be consistent in its approach and focus even if there are changes in the company's investor base. A framework that encourages the represented shareholders to provide an indication of their voting intentions on specific matters would be helpful for companies and increase genuine engagement.

Greater clarity about the intended purpose of the investor forum would be welcome. If the intention is to foster longer-term engagement between the forum and the company, we believe that it would be preferable for a forum to meet with the company on a regular, perhaps annual, basis, rather than convening meetings in response to particular events or crises. This latter approach would not foster continuity and may adversely impact on management's ability to manage such events successfully. We would not, in any event, wish to see such meetings having to be scheduled too often, as there will be an associated cost as well as time and administration involved in convening and attending them, both for the company and investors. We also consider that there must be doubts as to the practicalities of events-driven meetings because of the difficulties there would be in setting the criteria to establish when a relevant event has occurred and ascertaining when such criteria are met so as to require a meeting. There may also be difficulty in arranging meetings on short notice to canvas views on events which are of an urgent nature. It is also not wholly clear whether the forum would be intended to replace or be in addition to the frequent and regular meetings which many companies' senior executives typically already have with fund managers and others at major institutional shareholders as part of companies' regular "investor roadshows" in the weeks following results announcements.

The agenda for any such forum would have to be carefully considered and, in particular, it would have to take account of the difficulties around disclosing confidential and/or inside information. This may also hinder the practicality of holding meetings in response to certain events rather than as regular fixtures.

Furthermore, it is important from the point of view of shareholder democracy that engagement with such forums is not seen as a substitute for putting matters to shareholders generally and that these proposals do not result in a conflict with Principle 5 of the UKLA Listing Rules which requires a listed company to ensure that it treats all holders of the same class of listed equity securities that are in the same position equally. As a related point and, as highlighted above, the composition of a forum would require careful consideration to avoid the consequence of concentrating influence in a small number of represented shareholders.

2.5 Recommendation 4: The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves.

We are not sure what is meant by the comments at paragraph 3.26 of the Government's response, and, in particular, the point that "the Government believes it would be appropriate for government to take a greater interest in mergers and acquisitions". We also consider that reference in the Kay review to the Government and regulatory authorities using "informal authority" to be particularly unhelpful. We believe that all parties should be able to rely on a clear and transparent set of rules without having to be concerned about possible Government intervention based on evanescent political considerations which happen to be relevant at the time.

We believe that it is right that the Government should impose rules and regulations to regulate properly the conduct of mergers and acquisitions, but we believe that the current provisions of the Takeover Code as enforced and interpreted by the Takeover Panel, together with the merger control regime, do this job very well.

2.6 Recommendation 5: Companies should consult their major long-term investors over major board appointments.

Unlike the other recommendations, this seems to be a very specific new requirement and we would welcome greater clarity on what might be proposed. For instance, it is not apparent to us what the Government would regard as major board appointments for this purpose. The Kay Report envisages that the chairman and "important non-executive appointments" would fall within this category. However, "major board appointments" could include executive director appointments.

Information about individual appointments, particularly for senior or executive directors, may constitute price-sensitive information about a company. The disclosure (or delay in disclosure) and the dissemination of such information is therefore subject to significant regulatory constraints (for example, pursuant to DTR 2). If the information is considered to be inside information, the investor would need to be wall-crossed prior to any discussions. This may be problematic as, in our experience, institutional investors are unlikely to agree to this if discussions are continuing for any period of weeks, as they would be prevented from dealing for a prolonged period of time. In addition, consulting with a number of investors may also increase the risk of a leak, even if confidentiality arrangements are imposed. We note that it is suggested that an investor forum may be an appropriate venue for these discussions. For the reasons set out previously, we doubt whether this is workable in practice.

As a more general point, confidentiality is vital for prospective board appointments, not only from the company's perspective but also, in many cases, for the candidate and for any other company of which the candidate is already a director. We think that there would be a risk that sensitive negotiations could be jeopardised if the company had to share information with investors before or during the process.

The existing legal and corporate governance framework applicable to UK companies already provides shareholders with significant influence over board appointments and it is not clear to us what "consultation" means in this context.

In addition, there may be circumstances where a requirement to consult shareholders could undermine a board's ability to act in the best interests of shareholders as a whole—for example, where a board is seeking to appoint a new independent non-executive director in order to bolster the independence of a board in the face of a significant or founding shareholder with its own agenda, the requirement to consult might lead the shareholder to take action to frustrate the board's choice of independent director. Rules requiring consultation would in our view run the risk of being too prescriptive and interfering with the board's ability to act in the interests of all shareholders.

We would welcome more specificity on the proposals, in particular, as to the level and nature of discussions envisaged by this recommendation.

In conclusion, we do not believe that this recommendation would work in relation to the proposed appointment of individuals to specific posts. We do, however, think that there would be merit in there being dialogue between companies and investors, as there currently often is, regarding the general composition of the board, succession planning, and whether there is a need for additional skills or experience to be represented.

2.7 Recommendation 6: *Companies should seek to disengage from the process of managing short-term earnings expectations and announcements.*

Whilst we welcome Recommendation 6 and, in particular, the changes that will see an end to the mandatory requirement for UK companies to produce quarterly reports, we believe it is important to note that for many international companies the position is not necessarily that simple. For UK companies with international businesses, notably those with operations or listings in the US, there may still be a legal or regulatory requirement to report more frequently and/or in a way that engenders a short-term view. Even in the absence of a formal requirement, where UK companies have a sizeable international investor base, there may be an expectation on the part of non-UK investors of more frequent reporting than may be required in the UK. While changes to EU or UK laws and regulations are, therefore, to be welcomed, it may be that for many companies, the changes will not alleviate the situation and/or lead to the shift in focus that is desired.

We also believe that to give real effect to this proposal changes in UK/EU regulation may be required. At present, UK listed companies are under obligations to disclose inside information to the market as soon as possible. This means that any information which may have a significant impact on share price (however short-term) has to be disclosed and, indeed, recent pronouncements by the FSA appear to demonstrate the FSA's belief that disclosure (under DTR 2) is required in respect of any information which may be relevant to a reasonable investor, even where this would not be likely to be price-sensitive, though others argue that this is an incorrect interpretation of FSMA. So the Disclosure and Transparency Rules are themselves straight-jacketing companies into announcing short-term information and, in our view, this is bound to lead to companies seeking to manage short-term expectations. Therefore, whilst we consider the Kay review proposals for companies to focus on the long-term rather than to expend energy about managing short-term expectations to be laudable, we have doubts about the ability to effect changes in this connection without a change in the Disclosure and Transparency Rules, which themselves reflect EU law.

2.8 Recommendation 11: *Mandatory IMS (quarterly reporting) obligations should be removed.*

See our comments on Recommendation 6 above.

2.9 Recommendation 12: *High quality, succinct narrative reporting should be strongly encouraged.*

We endorse this recommendation. However, in order to ensure its success, we believe it will be important to ensure that there is a “joined-up” approach between all legislative and regulatory bodies as, although in the UK there is an attempt to “de-clutter” annual reports, this principle needs to be consistently applied.

As noted in paragraph 2.8 above, we would also note that for UK companies with international investors and/or operations there may still be a strong expectation, if not actual legal or regulatory requirements, for more discursive reporting. In this respect, we particularly feel that it would be useful for the Government to liaise with the US Securities and Exchange Commission (SEC) in relation to the level of reporting that is required for SEC registered UK companies. If not, any streamlining of the UK position would be undermined by US regulation which, generally, requires more detailed reporting.

2.10 Recommendation 14: *Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment.*

We endorse this recommendation. However, we would again make the point set out in paragraphs 2.8 and 2.9, that the international nature of many UK companies may mean that such companies may still be required, or be expected, to comply with regimes which do prescribe specific models.

2.11 Recommendation 15: *Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business.*

We support the principle set out in the first sentence. We do not agree with the principle in the second sentence for the following reasons;

- in any remuneration structure it is important to preserve an element of flexibility. Different businesses operate in different ways and the nature of their operations can mean that different reward structures suit different businesses. Any changes to the executive remuneration regime need to preserve such an element of flexibility. For companies whose business model and cycles make it appropriate to structure compensation in this way, then they can already do so. But it is unlikely that there can be a “one size fits all” type of policy;
- such a policy is likely to make it considerably harder to attract good candidates. This is likely to be a particular issue for the many London-listed companies' which have some or all of their operations and/or directors located outside the UK in jurisdictions where there is no equivalent policy. In such circumstances, exporting such a UK standard could make it very difficult to attract and retain talent;

- in many cases, performance related pay has become a significant part of the remuneration package relative to basic pay. In these cases, directors will have come to rely on the performance related pay and deferral for the length of time envisaged by the Recommendation may be impractical;
- such a policy may simply shift the emphasis from performance related pay to basic pay (see the point above) which could possibly mean that there is less incentive for management to pursue performance enhancing strategies; and
- such a policy may also be counter-productive, and encourage the early resignation of successful executives (to trigger release of their long-term incentive gains), leading to an increased ‘churn’ of executives, and thereby reducing the long-term strategic focus that is being sought by implementing such a policy.

If it is concluded that an obligation to hold shares in the longer-term is required, we wonder if there may be better ways to achieve this. For example, many companies already have a requirement for executive directors to hold a significant number of shares in the company (for example, calculated by reference to a percentage of their base salary). Many companies are also introducing longer vesting periods. We believe these approaches are already being more effectively used to achieve the same objective.

2.12 Recommendation 16: *Asset management firms should similarly structure managers’ remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund.*

Whilst we do not consider that this recommendation is directly relevant to the GC100, many of our members have pension schemes which rely on the performance of asset managers to enhance the returns to their employees and pensioners and, therefore, have an interest in this recommendation. We, therefore, support the recommendation in principle and, in particular, the notion that it is long-term performance which should be incentivised and rewarded, although again we do not believe that it is necessarily the case that a fund manager should be required to retain his entire interest in the fund for the whole of his period of employment or responsibility for the fund, as opposed to a specified minimum level of interest.

2.13 Recommendation 17: *The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.*

We agree with the need to address this recommendation in the context of policy proposals relating to central securities depositories and securities law in the EU. We also think that it is necessary for any system to be able to cater to the wishes of shareholders—whilst some may wish to hold shares directly on an electronic register and take direct advantage of the rights and obligations of being a shareholder, there will be those who wish to hold shares through a nominee because they are happy to forego such direct involvement.

The cost and administrative burden for companies in moving to any new system and, in particular, where paper based shareholders have to be moved to any such system, need be borne in mind. It will be necessary to weigh up such factors with the benefits to be gained. We believe that there will, in any event, be a natural shift towards more technology driven systems and that companies will move in that direction at a time that best suits them. We doubt if it is worth obliging companies to adopt new systems which may mean they have to do so at a time which does not best suit their individual circumstances.

2.14 Annex A—*Good Practice Statement for Company Directors*

(a.) Paragraph 1

The law relating to directors’ duties has been codified in the Companies Act 2006 which sets out the factors which directors should consider in determining whether a decision will promote the success of the company. We believe that these provisions deal with the position adequately and consider that it would be unhelpful to include factors which overlap with the statutory factors but omit some and add others.

(b.) Paragraph 2

Whilst we acknowledge that this principle may be correct for many companies, we believe that it may not suit all companies. Each company will have to act in the way that best suits its own business and strategies. There are, of course, companies whose business *is* the management of a portfolio of financial interests.

(c.) Paragraph 3

Whilst we consider this point to be desirable, we believe that it is largely outside the control of directors—intermediation costs are set and controlled by third parties over whom directors have little or no control.

(d.) Paragraphs 4, 5, 6 and 7

We support the principles underlying these paragraphs as we can see that they are consistent with the objective of promoting a long-term focus. We do, however, consider that there are laws and regulations which, if not amended, may hinder the achievement of such a focus and perpetuate a more short-term approach.

Companies in the UK have traditionally been more reluctant than in other markets to provide clear financial guidance on longer term prospects. We perceive that this is an ingrained cultural approach, which we believe may have its roots in, or at least is reinforced by, two aspects of the regulatory regime within which listed companies operate:

- the rules on profit forecasts (both under the Prospectus Rules and the Takeover Code) discourage companies from producing explicit forecasts, at least for the near term—listed companies are materially constrained in their willingness to provide meaningful forward-looking financial information because profit forecasts published as part of regular reporting may require to be repeated (in circumstances where the directors face personal liability without the benefit of the protections provided by section 463 of the Companies Act 2006) and reported on by independent accountants;

the way the continuous disclosure obligations (for listed companies, under Chapter 2 of the Disclosure and Transparency Rules, implementing Article 6 of the Market Abuse Directive) are interpreted and enforced by the FSA tends to mean that if a company has provided financial guidance on its longer term prospects but there is a change in circumstances that makes achievement of that guidance more challenging it will be required to make early disclosure of that by issuing a profit warning. Generally, markets react adversely to such disclosures and companies may be reluctant to give guidance in order to reduce the risk of having to issue profit warnings.

If it is desirable to encourage UK companies to provide more specific forward-looking information, we think the rules require a major overhaul with a view to creating a climate in which efforts made in good faith by management to identify longer-term financial prospects are not perceived to expose the company concerned, and its management, to unacceptable regulatory risks. It may not be easy to achieve a balance between, on the one hand, the requirements of investor protection (given the risks associated with forward-looking statements that are inevitably to some extent speculative) and keeping the markets informed and, on the other hand, the need to facilitate better long term disclosure, but we think the effort should be made.

An appropriate safe-harbour regime that encourages companies to provide clear guidance on their financial prospects together with the companies' assumptions regarding external factors and risks that may prevent their achievement would provide a sounder basis for a focus on longer term performance.

(e.) Paragraph 10

Please see our comments on Recommendation 15 at paragraph 2.12 above.

(f.) Paragraph 11

Please see our comments on Recommendation 5 at paragraph 2.7 above.

(g.) Paragraph 12

Please see our comments on Recommendations 6 and 11 at paragraphs 2.8 and 2.9 above.

18 January 2013

Written evidence from BT Pension Scheme Management Ltd (BTPSM), Universities Superannuation Scheme (USS) Limited and Railpen Investments (RPMI)

As three of the UK's largest defined-benefit pension schemes, BTPS, USS and Railpen we welcome the direction of Professor Kay's final analysis and subsequent support by the UK government. By way of background our full submissions to the Kay Review's interim and final reports can be found on the BIS website.

While the Kay Review successfully analysed the problems which arise from short-termism, we believe further action is required to address some of the major structural causes.

One key area we believe requires focus is the role of pension funds/asset holders. For example, we believe that pension funds must play a central role in the governance and operation of any investor body charged with a stewardship role for all investors. This is because pension funds in general are less conflicted than asset managers and tend to collaborate more readily. In addition, pension funds have longer term investment strategies as our liabilities or commitments may stretch into decades.

Please find attached a copy of a joint letter we wrote to Professor Kay ahead of his final report which we would like to submit as evidence to the Committee. We would welcome a meeting with the Committee to discuss these issues in more detail.

ANNEX

COPY LETTER FROM BT PENSION SCHEME MANAGEMENT LTD, UNIVERSITIES
SUPERANNUATION SCHEME (USS) LIMITED AND RAILPEN INVESTMENTS (RPMI) TO
PROFESSOR JOHN KAY DATED 3 JULY 2012

Dear Professor Kay,

Thank you for taking the time to meet with us on 21 June. We hope you found the discussion as helpful as we did.

As you write your final report and recommendations we thought it might be helpful to reinforce some of the key points we have already made in our respective submissions to you.

As you know, we support your key objectives to introduce measures which could shorten the investment chain and better align interests across the chain to the long-term interests of pensioners. We welcome your analysis that there is a problem of excessive intermediation.

We would encourage you not only to analyse the consequences of the way intermediaries behave but also to address some of the major structural causes of their short-termism. To prevent further divestment by the UK's pension funds from the UK's equity markets we would encourage you to consider two recommendations:

- More scale in the pension fund industry should be encouraged to help owners better control their costs and their agents and reduce the need for intermediation. This is a particular problem in the defined contribution world, which is becoming in effect owned by the fund management community; aggregated vehicles with independent governance are likely to serve beneficiaries' interests better.
- Focus pension fund regulation and accounting on the long-term. The Pensions Regulator should allow for greater smoothing on the valuation of assets and liabilities, and the proposed Solvency II type capital requirements for pension schemes should be abandoned or delayed.⁵⁰ These changes are vital for allowing pension schemes to themselves incentivise asset managers (internal and external) for the long term.

As three of the UK's largest defined-benefit pension schemes, we have long recognised that stewardship is critical in protecting and enhancing the long term value of investments. While we recognise the need to link stewardship activities to investment decision-making, we do not believe that—given current incentive frameworks—it is in most asset managers' interests to undertake effective stewardship activities aligned to the interests of our beneficiaries. It is for these reasons that we believe oversight for stewardship must rest firmly with the pension scheme Trustees and executives. We also recommend that your proposed institutional investor body includes organisations that are closer to the ultimate beneficiaries to ensure their long term interests are properly represented.

It would also be helpful if your report recognises that there are likely to be different solutions to the agreed problems. For example, we have each adopted different models, none of which, it is worth noting, involves outsourcing stewardship functions to external investment managers. USS has adopted a largely in-house investment management and stewardship function. Railpen's investment management function is entirely outsourced with stewardship led internally with a partial outsourcing to a specialist provider. BTPS' investment management is outsourced and stewardship is undertaken by Hermes Equity Ownership Services (EOS) which sits within the asset manager BTPS owns.

For the smaller UK pension schemes who decide to delegate their responsibility for stewardship, we would recommend efforts should be made to form collaborations between asset owners similar to the voting alliance between USS and Railpen, and the collaborative alliance of over twenty investors under Hermes EOS. There may be other viable solutions, and we would welcome our peers working to develop these.

We welcome your analysis of the problems we face in confronting excessive intermediation in the investment chain. There are short-term vested interests, as well as poorly-aligned incentive frameworks that need to be addressed. We would welcome recommendations that could help asset owners assert their authority and ensure they are able to act for their own long term interests including 1) tools to permit asset owners to achieve scale in negotiations with agents over costs as well as in stewardship activities, and 2) reforms to the pension fund accounting and regulatory framework that encourage long term investing. A bolstering of the FRC's Stewardship Code, and particularly the role of asset owners as part of it, could also be an important element of aligning asset managers with owners' long term interests.

Yours sincerely

Natasha Landell-Mills
Universities Superannuation Scheme (USS) Ltd
Frank Curtiss
RPMI Railpen Investments

⁵⁰ See OECD discussion note, Promoting long-term investment by institutional investors. Please also see point 3 in the submission by institutional investors "Proposals to tackle problems with IFRS—submission to the Kay review", 25 June 2012.

Helene Winch
BT Pension Scheme Management Ltd

Written evidence submitted by The National Association of Pension Funds Limited

1. INTRODUCTION

1.1. The NAPF is the leading voice of workplace pensions in the UK. We speak for 1,300 pension schemes with some 16 million members and assets of around £900 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

1.2. We welcome the Committee's undertaking of this inquiry into the Kay Review of UK Equity Markets and Long-Term Decision Making. This is an important issue and one which is of considerable interest to our members; in the case of DB pension funds, their interest in a successful UK corporate sector extends beyond that of an equity investor to that of an unsecured creditor, by virtue of the sponsor backing of private sector schemes.

1.3. The NAPF warmly welcomed the government's launch of the Kay review as well as the government's response to Professor Kay's report, both of which we gladly hosted.

1.4. The NAPF believes that equity markets must work more effectively in the long-term interests of investors and savers, who need to be able to see that they are getting value for money. The analysis presented by professor Kay and which was endorsed by the Secretary of State for Business, Innovation and Skills, Vince Cable MP, was sound and rightly highlighted the range of challenges that need addressing.

1.5. In its response, the Government acknowledged that there had been broad acceptance of Professor Kay's analysis, though this was accompanied by some scepticism about whether change is achievable, and whether the Government, UK companies and the investment industry can bring it about.

1.6. While many of the issues we identified in our submission to the Kay review were addressed in varying degrees in the final report, we were disappointed that some of the positive discussion in Professor Kay's interim report failed to make its way into any of the recommendations within the final report. While to a very large extent the NAPF endorses Kay's conclusion that the chain of intermediaries in the investment process is too large and costly, we were underwhelmed with the proposed solution to address this which largely boiled down to: leave it to the market.

1.7. However, by endorsing Professor Kay's recommendations, the Government is giving a clear direction of travel, which will help pension funds play their part in reducing a short-term culture in UK companies and markets—the NAPF will endeavour to play its part in achieving this.

2. A REGULATORY ENVIRONMENT WHICH SUPPORTS LONGER TERM RISK-TAKING BY PENSION FUND INVESTORS

2.1. In recent years pension regulation has driven funds and their sponsors increasingly to take a shorter term view. The NAPF has written at length and commissioned research⁵¹ on IAS 19 which we see as driving sponsors to place excessive emphasis on accounting measures of solvency. Likewise the Pensions Regulator's guidance on recovery plans encourages schemes to reach full funding over quite short time horizons. In addition, the European Commission's moves to introduce a solvency test akin to that applied to insurance companies threatens still further to force more schemes to close to future accruals.

2.2. More generally, our members have had to deal with a regulatory environment which has been in constant flux for much of the past fifteen years or more. While most of these changes do not deal directly with investment matters there has all too often been a knock-on consequence for funds' investment policies which was not considered when evaluating the merits of new regulations.

2.3. Professor Kay acknowledges the above in his report and rightly states that regulation should focus on the establishment of market structures which provide appropriate incentives. Kay also rightly states that the possible extension of Solvency II principles to pension funds is a matter of particular concern—indeed we believe that the introduction of a Solvency II-style approach to pension scheme funding, represents the single biggest threat to UK defined benefit pension schemes and would equate to a *£291 billion* increase in scheme funding requirements. If sponsoring employers were required to put more funds into their pension schemes, then there would be less money available for investment and innovation, with a concomitant impact on growth.

3. GREATER TRANSPARENCY AROUND INVESTMENT FEES AND CHARGES

3.1. In our submission to the Kay review we indicated that there is a need for the asset management industry to improve its disclosure of charges, costs and remuneration structures in the light of the likely growth of the industry, following the introduction of auto-enrolment to pension funds from 2012.

⁵¹ Accounting for pensions, Leeds University Business School, 2011

3.2. This was an issue which Professor Kay picked up upon in his report and around which there was a particular focus by many last year. Pleasingly there has resultantly been a significant amount of progress. This includes a new joint industry Code of Conduct⁵² for disclosing information to employers on the charges made on workplace pensions. This Code should enable, for the first time, the consistent disclosure of charges and investment costs across the workplace pensions landscape.

4. FOSTERING GOOD PRACTICE

4.1. The Government agrees that “asset holders” have a key role to play in setting the incentives on asset managers, and believes a shift in behaviour in this area will be vital for fostering long-term engagement between asset managers and company directors. To achieve this behavioural change, it was suggested that the Stewardship Code should continue to develop its definition of Stewardship and a number of Good Practice Statements should be adopted by relevant parties.

4.2. Members of the NAPF have a clear interest in promoting the long term success of the companies in which they invest. For this reason we have since its launch in 2010 been a strong supporter of the UK Stewardship Code. We also fully support the recent revisions to the Code which were introduced in September 2012 and which we, like the government, believe have appropriately continued to develop the understanding of “stewardship”.

4.3. While the Stewardship Code in its first iteration was understandably focused towards asset managers, we are pleased to note that pension funds have themselves been embracing their stewardship responsibilities, the recent revisions to the Code which further clarify the responsibilities of asset owners and managers will further help.

4.4. In December 2012, the NAPF published its eighth annual survey of pension funds’ engagement with investee companies.⁵³ The results from this survey which included members with combined assets under management of £323 billion demonstrated that pension funds are beginning to foster a market for stewardship. The survey indicated that:

- 93% of respondents agreed that institutional investors (including pension funds) have stewardship responsibilities which include engaging with companies and voting.
- 71% of respondents had taken the stewardship activities and policies of asset managers into account when selecting them.
- An overwhelming majority (90%) of respondents had reviewed their asset managers’ application of the stewardship policy.
- 93% of respondents had exercised their votes in the UK (up from 90% in 2011) and there was a similar trend in other jurisdictions.

4.5. One of the issues our 2012 Engagement Survey flagged up was that the same level of progress is not necessarily being made by others in the investment chain, particularly among investment consultants.

4.6. Our survey indicated that investment consultants proactively raised the issue of stewardship with pension funds in only two out five cases (38%). In addition, when it was discussed, investment consultants recommended signing up to the Code in less than half of cases. As key intermediaries between pension funds and asset managers, investment consultants could do more to encourage the take-up of the Code by explaining its relevance to their pension fund clients. We believe that this could help drive more pension funds to sign up to the Code.

4.7. As indicated above, since its launch a significant number of pension funds have signed up to the Stewardship Code. However, in light of the recent revisions to the Code and increasing focus on the issue we do believe that the time is right for pension funds to review their approach to Stewardship, question whether it could be more effective and consider how they should undertake their Stewardship requirements.

4.8. For this reason, alongside the Government’s response to the Kay Report, the NAPF published its first ever Stewardship Policy⁵⁴ which aims to help pension funds understand and fulfil their responsibilities as investors and to become signatories to the Stewardship Code. As the results of our 2012 Engagement Survey demonstrate, many pension funds are already embracing their responsibilities in this area and we are encouraging and assisting others to do likewise.

4.9. We also support the Good Practice Statements proposed by the Kay Review and endorsed by the government. The NAPF Stewardship Policy includes a number of principles for stewardship best practice, closely reflecting the direction set out in this area by Professor Kay in his Good Practice Statements. We will continue assess how else we can support the establishment of the principles contained within these Statements.

4.10. One area which pension funds could perhaps better utilise to reinforce a more long-termist perspective is via their assessments of the sponsor covenant. Within these private exercises trustees could be encouraged to more often consider factors beyond the financials, such as the sponsor company’s strategy and governance

⁵² *Pension Charges Made Clear: A Joint Industry Code of Conduct*

⁵³ NAPF Engagement Survey: pension funds’ engagement with investee companies, 2012

⁵⁴ NAPF Stewardship Policy, 2012

structures. While funds are encouraged to require their investment managers to take these factors into consideration when assessing investee companies, it is the investment from their sponsor which is perhaps most critical and with whom they have the most intimate relationship.

5. COLLABORATION AMONGST INSTITUTIONAL INVESTORS

5.1. While pension funds have reduced materially their exposure to UK equities in recent years, they remain significant investors in UK the market. However, it is clear that with this trend it is increasingly difficult for companies to easily “speak” to their shareholders and for shareholders to exert influence over their investee companies.

5.2. On this issue, it is worth reiterating the NAPF’s belief in the value of building scale and having fewer, larger schemes. In addition to helping savers secure better retirement outcomes because of the scale and efficiency they would bring, an increase in scale would leverage the voice and thus influence of pension funds in relation to their stewardship of investee companies.

5.3. The NAPF believes that engagement with investee companies is a vital part of the investment management process, however, as we know, pension funds are increasingly delegating their engagement activity to their investment manager. Our Engagement Survey therefore has for the past few years tracked the (perceived) level of collaboration amongst pension funds’ fund managers. For each of the past two surveys the response has been the same with 60% of respondents indicating that they are not aware of their fund managers collaborating with other investors on their behalf.

5.4. The recently published NAPF Stewardship Policy also picks up on this theme and states that funds should encourage collaboration between investment managers as a means of more effective engagement and voice. In addition, they should be clear about their managers’ approach and should expect a report on such collaboration.

5.5. We are however, very aware that a huge amount of collaboration amongst UK investors does take place, often on an informal basis. Indeed, we ourselves regularly host collaborative engagement meetings for our members with companies. This coordination role is one that is also performed by the ABI and other more informal groups such as the Corporate Governance Forum.

5.6. In the UK there are few obstacles to effective engagement between companies and their shareholders. However, the European Transparency Directive has been cited by some funds as a potential barrier to collaboration, given that an intention to vote at a company meeting in collaboration with other shareholders could require disclosure ahead of the meeting date. This presents potentially severe practical problems to investors and could inhibit effective collaboration. The recent announcement from the European Commission that as part of their company law and corporate governance action plan they will seek to increase legal certainty on whether collective engagement on governance matters falls foul of the rules on acting in concert is therefore a very positive one.

5.7. Professor Kay in his report recommends the creation of an Investors Forum to facilitate collective engagement by investors in UK companies. This proposal is one that has prompted a large amount of discussion by those in the industry and more widely.

5.8. As indicated above, we are conscious that a significant amount of collaboration already takes place amongst UK investors, however, as our Engagement Survey indicates, this is not always visible to the end clients, the press or the public. It is vital to keep in mind the necessity for most company engagement to take place in private, if these meetings were to become more public then the quantity and quality of the engagements would suffer.

5.9. That said, we do see merit in considering how investor collaboration can be further supportive and encouraged, especially in light of the broadening spread of a company’s investor base to include many more overseas and smaller investors. The NAPF therefore supports the creation of an investors’ forum that brings investors together to discuss, in a collaborative way, issues affecting them. It is important however, that any such forum is led by investors for investors.

6. ALIGN DIRECTORS’ PAY WITH LONG-TERM PERFORMANCE

6.1. The Kay review called for a revision of executive pay as part of the solution to short-termism in the markets. The Government in its response indicated that it too believes that Professor Kay’s prescription for long-term incentives—that these should be in the form of shares to be held beyond the individuals’ departure from the company—is an idea which companies should actively consider.

6.2. In recent years the NAPF has emphasised the need for pay restraint, coupled to improved transparency and greater simplicity. We welcome the recent attention on the issue which has helped focus minds on the need for a more fundamental rethink of executive pay structures to ensure much better alignment between rewards to management and the interests of long-term investors such as pension funds.

6.3. In February 2012 the NAPF and Hermes Equity Ownership Services (which undertakes voting and engagement for BTPS and other pension schemes) held an event on executive remuneration which was attended

by 44 FTSE 100 companies together with large pension funds both from the UK and overseas including RPMI Railpen and USS Investment Management.

6.4. Our sense from this, and other private and group meetings, is of a growing desire among many companies to re-evaluate current remuneration arrangements and embrace a new approach. We believe there is now an opportunity, which should be seized by companies and investors, to better align pay with the long-term owners of companies.

6.5. We firmly believe that the best form of alignment between executives and shareholders is the ownership of shares over the long-term, with ownership obligations increasing with seniority. The bulk of executives' variable rewards should flow over time from the benefits of being an equity owner. This approach we believe will help position companies for future success—an objective shared by all.

7. CONCLUSION

7.1. In conclusion, the NAPF is very supportive of attempts to consider the vital issue of how to structure the market such that it incentivises and rewards long-termism.

7.2. Pension funds by their very nature are long-term investors. However, in recent years, as a result of the move by investors around the world to diversify outside their domestic market, the growing maturity of many DB schemes and the effects of pension regulation introduced in recent years, there has been a trend away from UK equities. On the whole though pension funds still remain significant investors in UK the market and their interest in a successful UK corporate sector extends beyond that of an equity investor to that of an unsecured creditor, by virtue of the sponsor backing of private sector schemes.

7.3. We believe that what is needed is a regulatory environment which is more supportive of longer term risk-taking by pension fund investors—specific obstacles include accounting standards; inflexibility around recovery plans; and Solvency II (via the IORP Directive). In addition the positive trend towards greater transparency around investment fees and charges needs to be maintained.

7.4. Our research indicates that pension funds are embracing their stewardship responsibilities and our recently published NAPF Stewardship Policy explains further how funds should fulfil these responsibilities. However, our Engagement Survey also indicates that others in the investment chain have yet to embrace their responsibilities in this area.

7.5. This point highlights one of the more underwhelming aspects of the Kay report, that being the lack of any firm recommendations to address the issues raised with regards to the length (and cost) of the investment chain. Whilst the positive effort to improve transparency over charges and fees is important more is perhaps needed here.

7.6. Given the growing geographical diversity of the shareholder base for most companies it is unlikely that many will in future be able to rely on the support of a few stable, long-term shareholders. As such this places a greater onus on boards to develop a strategy, assess its execution and communicate this ever more effectively to their investors. In hand with this, institutional investors need to continue to develop effective mechanisms through which to collaborate. As such the NAPF will be working with others to assess how Professor Kay's recommendation for an Investors Forum can be practically and effectively progressed.

7.7. Finally, we agree with the logic of the government publishing a progress report, in Summer 2014, to highlight progress across this agenda. This a broad and vital agenda and it is important that momentum is maintained in order that change is achieved.

David Paterson
Head of Corporate Governance
 NAPF
 18 January 2013

Written evidence submitted by the Quoted Companies Alliance

The Quoted Companies Alliance is an independent membership organisation that champions the interests of small to mid-size quoted companies. Their individual market capitalisations tend to be below £500 million.

The Quoted Companies Alliance is a founder member of EuropeanIssuers, which represents over 9,000 quoted companies in fourteen European countries.

Our Corporate Governance Expert Group has examined your proposals and advised on this response. A list of members of the Expert Group is at Appendix A.

RESPONSE

We are grateful for the opportunity to submit our views to you on the recommendations emanating from the Kay Review.

Whilst we are generally supportive of the recommendations made by Professor Kay, we continue to have major concerns that the Kay Review has been developed on an assumption that the equity markets no longer have a primary, finance raising function. The report says:

2.6 Equity markets have not been an important source of capital for new investment in British business for many years. Large UK companies are self-financing—the cash flow they obtain from operations through profits and depreciation is more than sufficient for their investment needs. This is true of the quoted company sector as a whole and of a large majority of companies within it.

2.7 Finance raised through placings and rights issues by established companies, and initial public offerings (IPOs) by new companies, have generally been more than offset by the acquisition of shares for cash in takeovers and through share buyback (see Figure 4). New equity issuance has therefore been negative over the last decade.

Equity markets remain an essential source of capital for new investment in British business. Small and mid-size quoted companies are not self-financing and are undertaking activity which is rarely supported by senior finance, whatever the investment environment. Essential finance for the development of new economic growth is raised through share placings and rights issues by established companies and through IPOs by new companies.

Since the launch of AIM in 1995, over £80 billion of capital has been raised through new and further issues. This may have been offset by the acquisition of shares for cash in takeovers and through share buybacks. However, the larger companies, which conduct major programmes for the acquisitions of shares, are mature, ex-growth companies. Such companies are stable cash-generative machines which, understandably, return cash to shareholders. Large multinational companies listed in the UK do not typically create new employment in the UK and the rest of Europe.

Inevitably, the amount of cash returned to shareholders by larger companies is a greater amount than that raised by small and mid-size quoted companies—or “growth companies”. Each growth company needs essential capital to develop; often this is not a great amount. The cash volumes raised by growth companies are necessary to deliver new employment, economic activity, government revenues and economic returns to investors. Even if this is, in total, a smaller amount than that paid back to shareholders by large companies, each pound invested to deliver new growth is worth a multiple in the wider economy, as has recently been highlighted in Lord Heseltine’s report *No Stone Unturned in Pursuit of Growth*.

We urge the Select Committee to focus on the role of equity markets as a key source of capital for growth companies. Private equity and corporate debt have a role to play but companies need a range of options and equity markets need to be one of these, not least as an exit route for early investors. The most recent QCA/BDO Small and Mid-Cap Sentiment Index,⁵⁵ published in November 2012, reported that in terms of funding sources public equity and listed debt issuance were both growing in attractiveness at the expense of bank finance and private equity. 50% of respondents chose public equity as their preferred source of finance if the need arose in the next 12 months.⁵⁶

We agree with Professor Kay’s analysis that at the present time the primary equity markets are not functioning effectively. We believe that it is time for a fundamental review of the primary equity markets to ensure they are fit for purpose to support the raising of capital and the liquidity that goes hand in hand with investment both in 2013 and for the years to come. The continued concentration of mind by regulators, policymakers and lawmakers, at both UK and European levels, on share trading in the largest companies in the secondary market means that the primary equity markets are being starved of essential support in the delivery of investment and capital.

QUOTED COMPANIES ALLIANCE CORPORATE GOVERNANCE GUIDELINES FOR SMALLER QUOTED COMPANIES

The Select Committee will be interested to be aware that we are currently reviewing our *Corporate Governance Guidelines for Smaller Quoted Companies* (last published in September 2010), which is the industry benchmark for AIM companies, to take account of evolving best practice and, amongst other things, new legislative initiatives at UK and European level, evolution in the UK Corporate Governance Code and the Stewardship Code and the work of Professor Kay. In our update we will be incorporating the key features of the Good Practice Statement for Company Directors into the text and, more generally, promoting this part of Professor Kay’s work as a helpful guide to directors and companies, along with an increased focus on the need for effective Stewardship and the benefits of all types of Diversity.

If you would like to discuss any part of our evidence in more detail, we would be happy to attend a meeting.

Tim Ward

⁵⁵ <http://bdoqcasentimentindex.co.uk/>

⁵⁶ The survey figures are based on a quarterly online survey across the small and mid-cap quoted sector, with members and associates of the Quoted Companies Alliance (QCA) and contacts of BDO. The responding sample is weighted by industry to be representative of small and mid-cap UK quoted companies, as derived by the London Stock Exchange. Fieldwork was undertaken by research company YouGov. Fieldwork for the November Index was undertaken between 12/09/12 and 03/10/12, and the sample size was 200 adults. The survey respondents included 74% of small and mid-cap company employees in a board level position and 45% of advisors in a senior management position.

Chief Executive
18 January 2013

APPENDIX A

QUOTED COMPANIES ALLIANCE CORPORATE GOVERNANCE EXPERT GROUP

Edward Craft (Chairman) Wedlake Bell LLP
Victoria Barron Hermes Equity Ownership Services
Edward Beale Western Selection Plc
Tim Bird Field Fisher Waterhouse
Dan Burns McguireWoods
Anthony Carey Mazars LLP
Louis Cooper Crowe Clark Whitehill LLP
Victoria Dalby Capita Registrars Ltd
Kate Elsdon PricewaterhouseCoopers LLP
David Firth Penna Consulting PLC
David Fuller CLS Holdings PLC
Clive Garston DAC Beachcroft LLP
Nick Graves Burges Salmon
Alexandra Hockenhull Xchanging plc
David Isherwood BDO LLP
Nick Janmohamed Speechly Bircham LLP
Colin Jones UHY Hacker Young
Dalia Joseph Oriel Securities Limited
Doris Ko Aviva Investors
Claire Noyce/Deepak Reddy Hybridan LLP
James Parkes CMS Cameron McKenna LLP
Julie Stanbrook Hogan Lovells International LLP
Peter Swabey Equiniti
Eugenia Unanyants-Jackson F&C Investments
Melanie Wadsworth Faegre Baker Daniels LLP
Cliff Weight MM & K Limited

Written evidence submitted by BlackRock

BlackRock welcomes the opportunity to respond to the request for evidence made by the House of Commons and the Department for Business, Innovation & Skills on the Kay review. We set out in the attached response our view on 16 of the 17 principles recommended by Professor John Kay in his final report published in July 2012.

BlackRock is a leader in investment management, risk management and advisory services for institutional and retail clients worldwide. As at 31 December, 2012, BlackRock's AUM was \$3.792 trillion (£2.332 trillion). BlackRock offers products that span the risk spectrum to meet clients' needs, including active, enhanced and index strategies across markets and asset classes. Products are offered in a variety of structures including separate accounts, mutual funds, iShares® (exchange-traded funds), and other pooled investment vehicles. BlackRock also offers risk management, advisory and enterprise investment system services to a broad base of institutional investors through BlackRock Solutions®.

In Europe specifically, BlackRock has a pan-European client base serviced from close to 20 offices across the continent. Public sector and multi-employer pension plans, insurance companies, third-party distributors and mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals invest with BlackRock. BlackRock pays due regards of its clients' interests and it is from this perspective that we engage on all matters of public policy. BlackRock supports regulatory reform globally where it increases transparency, protects investors, facilitates responsible growth of capital markets and, based on thorough cost-benefit analyses, preserves consumer choice.

BlackRock is a member of European Fund and Asset Management Association ("EFAMA") and a number of national industry associations⁵⁷ reflecting our pan-European activities and reach.

We thank you for the opportunity to address and comment on the issues raised by the Kay review. We are prepared to assist the House of Commons and the Department for Business, Innovation and Skills in any way we can, and look forward to continued dialogue on these important issues.

Joanna Cound

⁵⁷ Association of British Insurers (ABI), Association Française de Gestion (AFG), Assogestioni, Association française des Sociétés financières (ASF), Association suisse des institutions de prévoyance (ASIP), Bundesverband Investment and Asset Management (BVI), Dutch Fund and Asset Management Association (DUFAS), Eumedion, Financial Reporting Council (FRC), Irish Association of Pension Funds (IAPF), Irish Funds Industry Association (IFIA), Investment Management Association (IMA), Inverco, Alternative Investment Management Association (AIMA) and National Association of Pension Funds (NAPF).

*Managing Director
Head of EMEA Government Affairs & Public Policy*

*Amra Balic
Director
Head of Corporate Governance and Responsible Investment EMEA*

18 January 2013

EXECUTIVE SUMMARY

1. BlackRock is supportive of most of Professor John Kay's 17 Recommendations developed in his final report on his review of the UK equity market.

2. BlackRock strongly supports the continuing development of a robust corporate governance regime. This, in our opinion, promotes strong leadership by boards and good management practices both of which contribute to the long-term success of companies and protects and enhances long-term shareholder value. As such, we engage with companies in which we invest on behalf of our clients dedicating our time generally to one-to-one meetings where we discuss, amongst other issues, the companies' strategic direction and the performance of management in delivering strategy.

3. BlackRock believes that there are merits in the development of the formation of an investor forum to strengthen corporate governance in companies in which we invest but has a number of reservations as to its scope of engagement and relationship with existing forums led by trade associations. In addition, while we discuss collectively with other investors when we believe this is likely to enhance our ability to engage with a company, the establishment of an investor forum poses a number of challenges which we develop in our attached response. Also, BlackRock does not think mandatory consultation by companies of their major shareholders over board appointments is appropriate for companies and/or investors. This would raise several practical questions such as inside information issues.

4. BlackRock does not consider that further changes to the application of fiduciary standards by asset managers at an EU level are required. BlackRock fully understands and endorses its duty to act at all times in the best interests of clients to protect and enhance the economic value of the companies in which we invest on their behalf.

5. With regards to transparency *vis-à-vis* asset managers' clients, BlackRock is supportive of initiatives aiming at improving transparency of costs and fees. However, disclosing the full costs of certain transactions might not be technically feasible for asset managers. In addition, we support and already provide a high degree of transparency to end-investors in respect of stock lending activity. A portion of the additional income that this activity generates for end-investors is allocated to compensating the lending agent for the provision of this service. After the payment to the lending agent has been deducted, we agree that the remaining net revenue should be passed to the end-investors as incremental income.

6. With regards to transparency *vis-à-vis* companies' investors, BlackRock believes that the informative quality of the narrative reports should be improved and be presented in a concise and clear way. We support guidance rather than regulation to achieve this objective. However, we believe that quarterly reports potentially create an undue focus on short-term developments that may have little material impact over the longer term. We therefore agree that quarterly reporting should no longer be mandatory.

7. BlackRock welcomes the Government initiatives to explore with market participants, the regulators, academics and relevant representative and professional bodies the metrics and models used in the investment chain.

8. BlackRock agrees that "companies should structure directors' remuneration to link incentives to sustainable long-term business performance". However, we are not supportive of directors having to hold the shares of the company in which they work until after they have retired from the business as this could incentivise a higher turnover of directors in the company who leave simply in order to cash in their shares contrary to the long term interest of the company. BlackRock is also of the view that asset management firms should structure remuneration to align their interests with those of their clients. We show evidence in our detailed response that BlackRock's compensation structure encourages a focus on the medium to long-term.

9. Finally, BlackRock fully agrees with Professor John Kay that it is key for individual investors to have all their rights preserved when holding shares through electronic means at a cost-efficient basis. We would welcome any initiatives which may reduce the cost of electronic trading intermediation for individual investors and encourage their ability to vote.

INTRODUCTION

In this response, BlackRock expresses its views on 16 of the 17 Recommendations given by Professor John Kay in his final report published in July 2012. We provide as much as possible factual information and recommendations for actions that we hope will be insightful for the House of Commons and the BIS.

BLACKROCK'S RESPONSE TO THE HOUSE OF COMMONS AND BIS REQUEST FOR EVIDENCE ON THE KAY REVIEW

(1.) *The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.*

10. BlackRock agrees with Professor John Kay's first recommendation. In our experience, the most important factors in determining success of a company are the strong leadership and execution of a company's strategy. As part of our engagement with companies, the BlackRock Corporate Governance team discusses with companies in which we invest strategy and execution issues and also aims to reach a better understanding on broader corporate governance policies and procedures and how executive pay is linked to achievement of the strategic goals.

11. It is worth noting that BlackRock approaches each engagement individually and does not have a prescribed escalation strategy, as suggested by the UK Stewardship Code, as we do not see engagement as mechanistic. Triggers for engagement can include our assessment that there is potential for material economic ramifications for shareholders resulting from a governance concern. Indeed, where we are concerned about the strategic direction the company is taking or the performance of management in delivering strategy, we will engage more heavily and through regular and frank meetings with management, we try as much as possible to raise queries before they become significant concerns that require greater attention.

12. BlackRock is very unlikely to make public statements about our engagements or to call an extraordinary general meeting or propose shareholder resolutions. Our preference is to engage privately as we believe it better serves the long-term interests of our clients to establish relationships, and a reputation, with companies that enhances rather than hinders dialogue.

13. Last, it is important to clarify that BlackRock defines stewardship as protecting and enhancing the value of the assets entrusted to us by our clients. As shareholders, our stewardship responsibility is to our clients. Yet we perceive a widespread belief that stewardship implies that shareholders have a responsibility to engage with companies and "make them better". This confuses the two responsibilities. Sometimes fulfilling our stewardship responsibilities to clients will involve engagement with companies; other times it will necessitate selling or reducing a shareholding if we cannot protect our clients' interests through engagement, which should not be seen as a derogation of our duty, but a fulfilment of it.

(2.) *Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Kay review's Good Practice Statements.*

14. BlackRock supports this second recommendation made in the final Kay report. We are a member of the Institute of Chartered Secretaries and Administrators (ICSA) steering group created in the summer of 2012 to improve the Quality of Investor Stewardship. This was at the request of the 2020 Investor Stewardship Working Group, of which BlackRock is a founding member. The steering group is developing a good practice guide to improve the quality of engagement activity and aims to identify more effective means for companies and institutional investors to provide feedback on the quality of meetings.

15. BlackRock believes that corporate governance and engagement are an integral part of an asset manager's fiduciary duty to enhance the value of its clients' assets and to ensure management are running the company in the best long-term interest of shareholders. In observance of our fiduciary duties to our clients, we: (i) as already mentioned above, engage with companies we invest in on a number of corporate governance and performance related issues; (ii) vote at shareholder meetings (for those clients who have given us a legal right through the Investment Management Agreement to vote on their behalf) and (iii) engage on wider policy issues that are in our view fundamental to protection of investors and their rights as shareholders.

(3.) *An investors' forum should be established to facilitate collective engagement by investors in UK companies.*

16. In principle, we are in favour of creating an investor forum that would (further) facilitate collective engagement. However, we also acknowledge that there are some challenges, such as:

- Minimise/limit overlaps and duplication of efforts: the new forum needs to cover topics/issues that go beyond the typical discussions currently conducted through the existing industry bodies (ie Association of British Insurers (ABI), National Association of Pension Funds (NAPF) and Investment Management Association (IMA)).
- The forum's governance policies need to ensure confidentiality of the meetings and views expressed as this aspect will be the key determining factor of the forum's effectiveness and ultimate success.
- The governance policies and terms of reference also need to be designed to allow effective actions in a way which does not conflict with rules on market abuse and acting as concert party in view of a takeover bid.

17. As UK Plc. (companies registered in the UK) is decreasingly owned by UK savers, bringing some large foreign investors (such as sovereign wealth funds) to the table would broaden the discussion and enable exchange of views.

18. In general terms, as a large investor in UK companies, BlackRock will work with other investors, often on an ad hoc basis, when we believe it is likely to enhance our ability to engage with a company or to achieve the desired outcome. This facilitates communication between shareholders and companies on corporate governance and social, ethical and environmental matters. We will also engage collectively on matters of public policy, when appropriate.

(4.) The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves.

19. We do not have comments on this principle.

(5.) Companies should consult their major long-term investors over major board appointments.

20. BlackRock agrees in principle that companies should consult their major investors over the key board appointments. However, we do not see the need to make this consultation mandatory for companies and/or investors. Both parties should be allowed to determine if or when the consultation is necessary. We also acknowledge that there are some practical issues surrounding this type of engagement and consultation that need to be discussed further. Specifically, there are issues in relation to inside information and wall crossing, timing of consultation and subsequent communication with investors.

21. It is also worth pointing out that today companies and investors are already engaging over the major appointments but those conversations vary for the reasons cited above. At a minimum, investors will have a view on the background and skill set required. At the same time, investors will unlikely want to be made insiders for an extended period of time depending on a number of factors such as investment strategy, size of holding, company performance etc. In this case, we would urge the House of Common and BIS to take into account current developments in the market abuse regime such as the European Union Market Abuse Regulation and to ensure that appropriate balance is reached between investors' engagements and preventing market abuse.

(6.) Companies should seek to disengage from the process of managing short term earnings expectations and announcements.

22. Based on our experience in recent years, the demand for greater disclosure on short term earnings, such as quarterly reporting and the operating review, has helped boards to communicate better their long-term strategic objectives. However, quarterly reporting does potentially places undue focus on short-term developments that may have little material impact over the longer term. Too frequent disclosure can make the market lose sight of the longer term objectives and judge the company on its short-term achievements. This, in turn, might make it more difficult for boards to focus on the long-term development of their business. Therefore, BlackRock supports moves to drop the requirement for mandatory quarterly reporting. This will allow companies to be freer to disengage from the process of managing short term earnings expectations and announcements and focus more on their long-term objectives. We develop this point further in our comments to Recommendation 11.

(7.) Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.

23. BlackRock does not consider that implementing a new fiduciary standard at an EU level is required for asset managers. We believe that UK asset managers understand their obligations, which include contractual (setting the scope of who a manager's customer is, the guidelines to be applied, etc.) and regulatory (both at an EU or UK level) duties. These are high standards already.

24. In the UK we understand that fiduciary responsibility has been developed (and continues to develop) by case law and introducing an EU wide standard which cannot be contractually overridden may cause confusion and perhaps affect the competitiveness of the UK asset management industry.

(8.) Asset managers should make full disclosure of all costs, including actual or estimated transaction costs and performance fees charged to the fund.

25. BlackRock fully supports initiatives aiming at improving transparency of costs and fees. We do note that there are a number of ways of addressing this issue and in particular, for retail investors, this needs to be coordinated at a European Union level as part of the packaged retail investment products (PRIIPS) initiative.

26. However, providing full transparency of costs for non-equity product presents a number of challenges such as the effects of spreads on fixed income instruments. It is important that a common methodology is agreed which can apply across all product ranges.

27. Also, given unbundling of advisory fees from product specific fees in the UK retail distribution review (RDR), it is important that investors have a clear way of assessing total product cost and total investment cost (ie product and advice costs together). Asset managers will only be able to disclose the product cost to the end-investors but not the full cost of investing given they will not have information post-RDR on the fees end-investors will have to pay to the advisers. BlackRock is supportive of clear disclosure delivered by advisers to clients regarding the new fee arrangements.

28. As a member of the IMA and the NAPF, BlackRock endorses the efforts of both organisations to establish industry wide best practice on fee transparency and is currently working towards compliance across all client communication channels.

(9.) *The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers.*

29. BlackRock cannot comment on uncertainties and misunderstandings on the part of trustees. As referred to in Recommendation 7 above, we do not believe that additional clarity is needed for UK asset managers regarding the rules around being a fiduciary as these rules are sufficiently well understood under English law.

(10.) *All income from stock lending should be disclosed and rebated to investors.*

30. Stock lending is a well-established and low risk activity that is comprehensively regulated in Europe. Investment vehicles such as UCITS funds, ETFs, pension funds and insurance companies make short-term loans of their securities to banks and broker dealers, who, in return, provide collateral that is in excess of the value of the underlying loans. The funds receive the full economic value of the security lent including any dividends paid, and further receive a fee for lending their securities, which generates incremental returns for their portfolios contributing to the overall investment performance.

31. In addition, stock lending has wider benefits for financial markets as it provides liquidity that helps to improve settlement efficiency and contributes to tighter trading spreads for investors.

32. Stock lending is considered to be a low risk activity. The risk mitigation tools utilised include using high quality counterparties, over-collateralisation, and in some cases contractual indemnifications against losses as a result of borrower default.

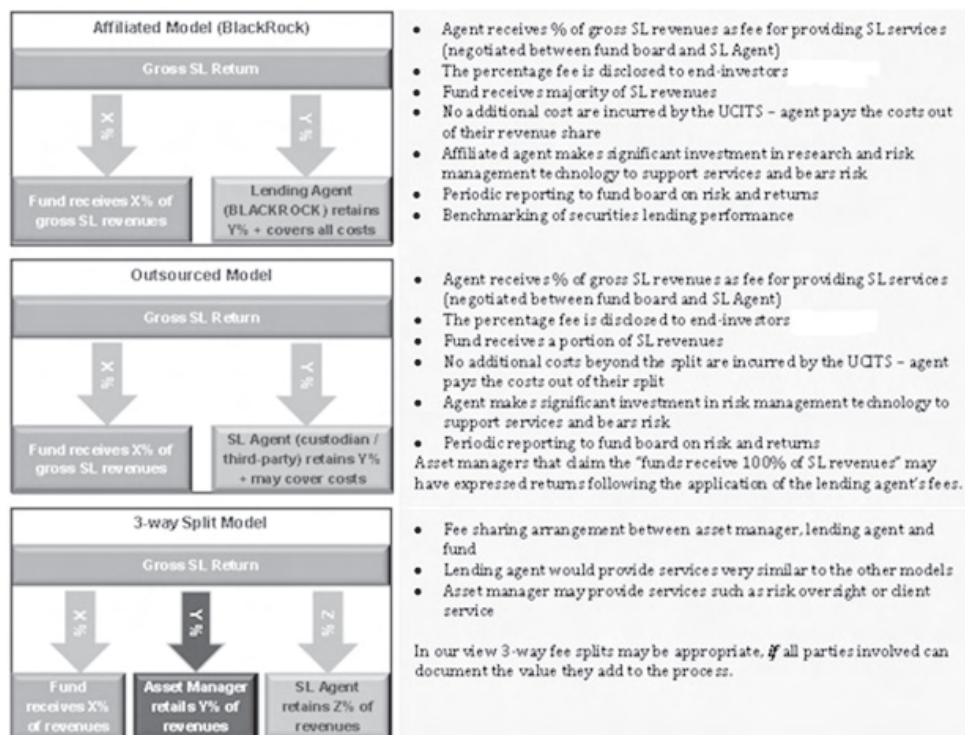
33. We support efforts to increase transparency on stock lending activities for end investors to ensure that are fully informed of the nature of risks and returns involved from this activity. We further support disclosure of the fees paid in connection with securities lending, in the same manner as other fees paid to fund service providers are disclosed. However, we do not agree that all income should be passed to investors given that running these activities represents a cost for the lending agents appointed by the funds.

- Stock lending is a resource-intensive activity. A high proportion of stock lending trades are executed automatically, which requires significant investment in systems and technology. A smaller number of trades are negotiated manually, where pricing can be influenced by many variables, and the outcome for end investors can be significantly improved through the application of quantitative and fundamental research and analytics. In addition, investment in risk management capabilities is required to continuously review counterparties and collateral parameters. Significant resources are also required to monitor settlement, collateralisation and corporate actions activity. These investments permit the lending agent to provide their trading expertise, scalability and risk controls across all lending clients. It is difficult to assign these costs to specific lending clients.

34. As a result, beneficial owners and the stock lending industry have established a model whereby the lending agent receives a percentage of gross revenues for their service of providing stock lending services. This model ensures that the lending agent is compensated only if the lending client generates revenue for the fund. In our view, paying the lending agent a percentage of the gross revenue generated is the most appropriate way of ensuring alignment between the interests of the investors and the lending agent.

35. There are at least three active compensation models being used for stock lending in the European markets today:

- (1.) *Affiliated Model:* In-house lending programmes, where the asset manager or an affiliate performs stock lending services as the lending agent. The agent receives a portion of the gross stock lending revenue generated.
- (2.) *Outsourced Model:* All stock lending services are outsourced to a lending agent, which could be a custodian, another asset manager or a specialised third-party lending provider. As before, the agent receives a proportion of the gross stock lending revenue generated.
- (3.) *Three-Way Split Model:* Stock lending is outsourced as in the second model, but the investment manager also receives part of the stock lending revenues. Fees are split between lending agent, fund and asset manager.



36. As explained above, we are not supportive of having all of the gross income generated from stock lending passed to end-investors. However, we do agree that transparency should be provided to clients so that they fully understand revenue sharing arrangements. We also believe that the cost of operating a lending programme should be paid by lending agent from their portion of the income. After the payment to the lending agent has been deducted, we agree that the remaining net revenue should be passed to the end-investors as incremental income.

(11.) *Mandatory IMS (quarterly reporting) obligations should be removed.*

37. As already mentioned on our comments to Recommendation 6, BlackRock supports moves to drop the requirement for mandatory quarterly reporting. While further investigation into the impact of quarterly reporting might be worthwhile, we believe that quarterly reporting potentially places undue focus on short-term developments that may not have a significant impact over the longer term.

38. Also, we think that consideration might be given to whether there should be more flexibility in reporting requirements, which can be disproportionately costly for smaller companies. Investor pragmatism and engagement would ensure that the right balance is achieved between meeting shareholder expectations and not unduly burdening smaller companies.

12) *High quality, succinct narrative reporting should be strongly encouraged.*

39. BlackRock agrees with this principle. We believe that the informative quality of the narrative reports should be improved whilst giving companies an appropriate level of flexibility in respect of the nature and scope of disclosure. We support guidance rather than regulation that would focus on balancing the need for reports to be complete and comparable with the need to be concise and accessible to all users.

40. Also, when preparing the annual report companies should focus on the matters material to the long-term success of the company and those that explain performance during the period under review. All focus should be on providing information to investors that is useful for making their investment decisions. We think that narrative highlights should give both what is most material in the long/medium term outlook and what the companies believe are material changes to previous narratives about that outlook. The areas that a business decides are most applicable can itself contain useful information. However, while we see value in providing additional information (as mentioned above), we also urge companies to present them in a concise and clear way.

(13.) *The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations.*

41. BlackRock welcomes the Government initiatives to explore with market participants, the regulators, academics and relevant representative and professional bodies the metrics and models used in the investment chain.

(14.) *Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment.*

42. BlackRock fully agrees with this principle.

(15.) *Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business.*

43. BlackRock agrees that "companies should structure directors' remuneration to relate incentives to sustainable long-term business performance". However, we do not believe that company shares are the only asset that can incentivise directors' long term performance. In some cases and in certain industries, shares coupled with subordinated debt/bonds can also be efficient. We do not agree either that the directors should hold the shares until after they have retired from the business as this may lead executives to leave the company when they think it is the best timing to cash in with adverse effects on the long term interest of the company.

(16.) *Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund.*

44. BlackRock agrees that asset management firms should structure remuneration to align the interests of asset managers with the expectations of their clients.

45. BlackRock's approach to compensation reflects the value senior management places on its clients, employees and shareholders. Consequently, the compensation structure is designed to align with client and shareholder interests, to reflect performance and to attract and retain the best talent and to reinforce stability through the organisation.

46. The predominant compensation model includes a salary and a discretionary bonus reflecting firm, business area, and individual performance. For most investment professionals, compensation reflects investment performance over the short, medium and long term and the success of the business or product area and the firm Variable compensation deferred from annual bonus awards is paid out in BlackRock's stock which vests over a number of years. In addition, a limited number of investment professionals have a portion of their annual discretionary awarded as deferred cash that notionally tracks investment in selected products managed by the employee. The intention of these awards is to align further investment professionals with the investment returns of the products they manage through the deferral of compensation into those products. Clients and external evaluators have increasingly viewed more favourably those products where key investors have "skin in the game" through significant personal investments. However, such co-investment is not always possible. For example, as a result of the significant compliance burden with respect to the US Foreign Account Tax Compliance Act (FATCA), a US national is generally precluded from investing in a UK fund. The combined effect of this approach means that the variable compensation an investment manager receives in any one year reflects the investment performance achieved over a considerable time period. BlackRock believes that this correctly aligns compensation with the client experience and that it is not appropriate for the incentive to be held until the investment manager is no longer responsible for a particular fund. The compensation structure outlined above is designed to retain best talent and reinforce stability of personnel (because clients select managers on long term performance and stability of investment processes and personnel). Withholding the deferred compensation until the investment manager no longer is responsible for the fund could instead encourage greater personnel turnover.

(17.) *The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.*

47. BlackRock would welcome initiatives which may reduce the cost of electronic trading intermediation for individual investors and safeguard and encourage their ability to vote. As such, we are of the view that it is important to find the most cost effective means for individual investors to hold shares electronically in their own name. We note that investors already have the ability to hold their shares electronically through nominees which represents a less significant cost for them than holding the shares in their own name. However, we are of the view that individual investors should have all their rights preserved when holding shares through electronic means.

48. BlackRock also believes that any such initiative needs to be viewed in the context of central securities depositaries and the proposed securities law directives.

Written evidence submitted by UK Shareholders Association

EVIDENCE TO THE BUSINESS, INNOVATION AND SKILLS COMMITTEE ON THE GOVERNMENT RESPONSE TO THE KAY REVIEW

UK Shareholders' Association is a long established non-profit body representing the interests of individual shareholders. In addition to the services we provide to our own members, we have a 20 year record of making representations to various public authorities on behalf of private investors in general, including three submissions to the Kay Review. We have a collective experience derived over many years from numerous, mainly long-term, investors. We also strive to play a role in the education of our members and investors generally. We are entirely funded by subscriptions from our members.

EXECUTIVE SUMMARY

In this paper we express our disappointment with the Government Response, which lacks any sense of urgency and drive despite the Review being relevant to the overall economic performance of this country, as well as to relationships between companies and their shareholders. We give just a few examples from the Response to illustrate our concerns. One is the reliance on a broad group of departments and regulators to achieve progress on examination of law and regulation with a leisurely timetable but no one person or body indicated as driving it forward. Another is the reliance on the Stewardship Code despite evidence that it is not effective. A third is the excuse of waiting for European directives before taking action on rights for private shareholders.

OUR EVIDENCE:

1. We are extremely disappointed with the whole tone and attitude of the Government response, which has lost all the sense of urgency and initiative that accompanied the setting up of the Review when it was announced in June 2011. The Review does not merely deal with relationships between companies and shareholders but it leads into wider issues which have contributed to the economic decline of this country. For example, Professor Kay highlighted early in the Review the fact that both Business Investment and R&D investment in the UK have fallen in recent years and both are now significantly below those of our principal trading competitors. This aspect of the Review is passed over in the Government response and yet we would have thought this would be a key feature especially in the light of the difficulties there have been in engendering economic growth.

2. We are well aware that, while Kay gave an excellent analysis of what is wrong at present, and described the ideal situation he would like to reach, his route map for achieving the desirable result was lacking in detail. The Secretary of State seems to have accepted this as a reason for relying largely on market participants to achieve progress and, where Government is directly involved, not to propose any further progress report until summer 2014. We believe, on the contrary, that very little is likely to be achieved without a strong push from Government. Moreover any review dependent on "market participants" will surely be biased towards the interests of the financial services industry, which largely conducts its affairs with other people's money; those whose money it usually is, namely private investors and savers, are usually absent from such reviews and so need the Government to act on their behalf.

3. We continue by giving specific examples of some points in the Response where we can make positive suggestions.

4. CHAPTER 2

In paragraph 2.22 The Government "calls upon market practitioners to have regard to these principles". This in our view is completely inadequate to achieve any progress. A positive way forward would have been for the Secretary of State to call industry leaders together to bring their influence to bear in establishing these principles and threatening them with legislation if they failed to do so. In paragraph 2.29 the Response proposes to take forward the identification of changes in law and regulation by expecting three government departments plus the Cabinet Office to work jointly with five regulators. There is no indication in the Response of any one individual or Department having been given any power or responsibility to drive this forward. Moreover only in summer 2014 are we to hear how the Review is to be used to inform future policy development. That will be already two years from the publication of the Review, three from its commissioning and less than one year from a general election. This leisurely approach is totally inappropriate.

5. RECOMMENDATION I

The response here places great reliance on the development and application of the Stewardship Code. While we are supportive of the FRC's introduction of this Code and note the list of companies that have publicly signed up to it, which is no small achievement in itself, we have consistently pointed out the lack of incentive for major shareholders handling other people's money to allocate the necessary resources to make a good job of it; in fact, competitive factors provide a disincentive.

We are currently dealing with a case of an executive compensation scheme in a FTSE 250 company which appears to have been devised simply as a means of transferring wealth from the shareholders to the executives with very little in the way of performance requirement to achieve this. It is evident from the voting figures that

major institutions voted in favour of this package despite all its weaknesses and these appear to include some who have signed up to the Stewardship Code. This demonstrates that the Code is not working and that Government should be looking for alternatives such as shareholder committees involving shareholders with a real, long-term economic interest. We believe that this would provide a more fruitful opportunity for progress than the forum proposed in Recommendation 3.

6. RECOMMENDATION 10

At first sight the Government appears to have accepted this recommendation. However, closer reading indicates that they have skated over the possibility that stock-lending is carried out in whole or part for the benefit of the asset manager even though it is at the risk of, and possibly against the interest of, the ultimate investor. Here again there is a complete reliance on the investment industry to make progress coupled with a lack of urgency by deferring any further consideration to summer 2014.

7. RECOMMENDATION 17

7.1 The issues addressed by Professor Kay's final recommendation are long-standing and becoming more serious as time goes by. More and more shares have to be held through nominee accounts, either because the Government requires this for ISAs and SIPPs or under pressure from brokers because this gives them a degree of control from which they derive commercial benefit. This leads to the failure of shareholder democracy, loss of control over one's investments and the weakening of the pressure that private individuals are able to apply to boards of directors by challenging them at AGMs. Moreover, it appears to be a direct obstacle to the holding of shares by individuals, whereas we would have expected the Government to want to encourage this as a means of saving, with the additional benefit of wider understanding both of the way wealth is created and of the capitalist system in general.

7.2 As illustrated by Professor Kay, other countries have solved this dilemma although the countries he lists are not the only ones, and it seems to be unique to the UK. At the moment, the only way round the problem here is through holding a Personal Crest account. The idea of these becoming general is anathema to service providers for one reason and another and forbidden by HMRC for ISAs and SIPPs.

7.3 On page 31 of its response the Government gives potential EU legislation as a reason for holding back on further action. On the contrary, current EU proposals add considerable urgency to the need for progress since those concerning central securities depositories involve compulsory dematerialisation. If this were to occur without progress on Recommendation 17, the only private shareholders outside nominee accounts who retained their proper rights would be those who had adopted the Personal Crest system. Everyone else would be disenfranchised and AGMs would be non-functioning (a serious loss of director face-to-face accountability), since the vast majority of private shareholders would no longer have an automatic right to attend and vote.

7.4 Parliament should also be aware that, by means of Part 26 of the Companies Act 2006, it has allowed the acquisition of all of a company's equity without all its equity holders having a say in the matter. In corporate actions, of which this is the most dramatic, nominee account users, not being the legal owners of their shares, are usually excluded from the vote. Whether nominees vote the shares unbeknown to their clients is itself an unknown, but such acquisitions, now the majority, hand the acquirer 100% of the shares in what amounts to those disenfranchised as compulsory purchase, with no minimum voting participation (ie it can and has been less than 50%). The Government also loses revenue, because this method of acquisition avoids stamp duty.

7.5 Professor Kay expresses concern about the security of shares held in nominee accounts. The level of compensation available for loss of investments held in nominee accounts is just £50,000, whereas the equivalent figure in the USA is understood to be \$1m. Even if investors succeed in recovering all their investments when the nominee goes bust they will certainly have faced a lengthy period before any investment is returned or made available for sale. For ISAs and SIPPs, the Government denies savers the right to own their investments but has refused to recognise the extra financial risk this imposes.

7.6 It is essential that the Government legislates to remove the obstacles to what should be investors' right to be treated as full shareholders regardless of the means by which they hold their shares in individual companies. UKSA stands ready to contribute to the exploration of means that we acknowledge is first needed, but a clear lead from the Government on this crucial issue is needed now.

Roy Colbran, Head of Government Policy Group
John Hunter, Policy Team member
Eric Chalker, Policy Co-ordinator
 20 January 2013

Supplementary written evidence submitted by UK Shareholders Association

THE KAY REVIEW

Having now read or heard the evidence of witnesses in the oral sessions before your Committee, we wish to submit some comments supplementary to our own written evidence.

SESSION WITH LORD MYNERS

In the light of our own evidence you will appreciate that we were delighted to see Lord Myners's criticisms of the government response which were expressed more clearly and succinctly than we could manage. A parallel organisation also representing individual shareholders has written direct to the Secretary of State expressing concern about the response.

Lord Myners said that he did not think you had a single true owner giving you evidence. In fact our organisation's evidence is supplied by and on behalf of individual true owners. Our members join our association, and pay their subscriptions, because they are direct personal holders of shares, seek the support which we provide and, in return endorse our efforts to improve the environment in which private investors operate.

That leads on to the question of the amount of shares in private ownership which was discussed in the session on 26 February. First, in case the Committee is not already aware of it, you should know that Richard Jenkinson, Managing Director of Junction RDS Ltd, disputes the official figures claiming that they understate the true position and that the current trend is upwards. He has compiled a massive database to demonstrate this. His work is being taken sufficiently seriously for the FRC to commission an investigation into his figures although that does not seem to have progressed. However, he has also had conversations with the Office for National Statistics and would tell you that they have admitted some changes in their methodology resulting from his comments.

A useful comparison is with Australia where the latest survey shows 39% of the adult population holding shares directly. In the UK the ONS figures measure by households rather than by individuals and have only 15.4% holding UK shares. Comparison of the help provided for private investors on the websites of the respective stock exchanges gives an indication of the differing official attitudes towards them.

We would certainly like to see the proportion of shares in private ownership in this country grow as we believe that a strong private shareholder base is healthy for the economy, it promotes understanding of the ways in which the wealth of the country is generated and provides opportunities for savers under their own control. Private shareholders take a direct interest in the companies in which they invest and ask penetrating questions at AGMs from which the institutions are generally absent. Unfortunately there are factors militating against growth in their numbers including the pressure from advisers to buy funds, the lack of rights through nominee shareholdings, the feeling that only institutions have all the advantages to cope with today's complexity and the complications of keeping records for capital gains tax.

THE INVESTORS' FORUM

We have read Professor Kay's proposals for an investors' forum several times and still do not fully understand how this is intended to operate. The intention appears to be to create one amorphous body covering the whole of the UK stock market and we do not believe this can be effective. Clearly the prime objective is to encourage the growth and development of UK plc with the secondary, but vital, objective of the benefits from this feeding down to investors and savers. We believe that specific bodies need to be set up for each company rather than having one forum covering the whole market. UKSA would like to see shareholder committees made up of private investors. An alternative suggestion is for shareholder committees largely made up of institutions but with a private investor element. In both cases these committees would be for consultation and communication. However, this raises the question of whether the point has been reached where the directors of a company are so much in control that a body with positive powers over them is necessary. In this connection it is worth pointing out that according to Ferdinand Mount⁵⁸, Sir Richard Greenbury (of the Greenbury Committee) now advocates two-tier boards on the Continental model despite having ruled them out in the past. Maybe the time has come to examine more closely how this system operates in continental Europe, bearing in mind that we see a stronger industrial base combined with greater investment and R&D in countries such as Germany which has the system.

KAY RECOMMENDATION 17—RIGHTS FOR HOLDERS IN NOMINEE ACCOUNTS

Our written submission to your Committee sets out our position in regard to the Government's response on this topic. Since we wrote, a Draft European Parliament Legislative Resolution (A7-0039/2013) has been issued incorporating a Draft Regulation which will give member states that have not fully dematerialised a deadline to do so. This, of course, includes the UK. The explanatory statement continues: "In order for shareholders to play a more active role exercising their rights over companies it is necessary that central registers be kept that will facilitate the use of these rights." It follows that there is now no excuse for the

⁵⁸ The New Few; Ferdinand Mount 2012, Simon and Schuster UK Ltd

Government to wait on Europe before working fully with the share registrars and representatives of private investors to achieve a satisfactory solution to this problem. Full enfranchisement of private shareholders is essential if they are to be encouraged and to play their full part in achieving Professor Kay's aspirations.

Roy Colbran
Head of UKSA Government Policy Group
11 March 2013

Written evidence submitted by the Chartered Institute of Personnel and Development (CIPD)

BACKGROUND

1. The CIPD is the leading independent voice on workplace performance and skills. Our primary purpose is to improve the standard of people management and development across the economy and help our individual members do a better job for themselves and their organisations. Our purpose is to champion better work and working lives, through improving people management and development practices to build greater value for organisations, benefiting economies and society.

2. Public policy at the CIPD exists to inform and shape debate, government policy and legislation in order to enable higher performance at work and better pathways into work, especially for young people. Our views are informed by evidence from 135,000 members responsible for the recruitment, management and development of a large proportion of the UK workforce.

3. Our membership base is wide, with 60% of our members working in private sector services and manufacturing, 33% working in the public sector and 7% in the not-for-profit sector. In addition, 76% of the FTSE 100 companies have CIPD members at director level. We draw on our extensive research and the expertise and experience of our members on the front-line to highlight and promote new and best practice and produce practical guidance for the benefit of employers, employees and policy makers.

GENERAL COMMENTS

4. Public opinion of big businesses, particularly in the financial sector, has nosedived following recent events that demonstrated a lack of fundamental ethical positions and responsibilities in certain organisations, as well as how widely the behaviour of others differed from their stated values and ethics. This is by no means confined to the banks—surveys of public opinion show a significant decline in trust in all types of businesses doing the right thing, as well as authoritative figures such as politicians.

5. Events ranging from the fixing of the LIBOR rate to the mis-selling of PPI insurance have pointed to a crisis of culture existing within these organisations (albeit also reaching beyond particular institutions and sectors). Over time, the understanding of an organisation's purpose has become unduly biased towards short-term performance measures, reinforced by misaligned remuneration incentives at different levels of the organisation, at the expense of a focus on longer-term performance and business sustainability.

6. We welcomed the insights, conclusions and recommendations made by John Kay in his review into UK Equity Markets. We believe that the state of affairs outlined above is linked to a decidedly short-termist outlook that certain organisations and sectors have embodied for some time, driven by a focus on short-term financial and share price performance reinforced by remuneration and reward practices. This has been accompanied by a real and apparently increasing lack of long-term-focused investment behaviour, which belies a lack of long-term thinking and a failure to properly account for the needs of the organisation in the future. Organisations need to focus on those factors that will enable long-term sustainable business performance, both internally and externally, that go beyond simply the financial metrics.

7. We do not think it is either possible or desirable to legislate for culture change, believing instead that this is more likely to be achieved through clear identification of best practice and non-statutory routes. It is important to give businesses "ownership" of the way they grow and implement their own cultures—a "one size fits all" approach is unlikely to work. Changing an organisation's culture fundamentally requires changes in leadership behaviours and cannot happen overnight, but it begins at the top and is reinforced through performance measures and reward practices. However, we believe that many of the measures recommended in the Kay Review, if implemented properly, will go some way to ensuring more company directors to take a longer term, sustainable view of their business activities.

8. On directors' pay, we believe that this should not only be dependent on long-term performance, but that performance measures themselves should include a wider range of considerations that go beyond the purely financial and how much profit is being generated. The vast majority of today's shareholdings are traded in very short-term cycles, which runs counter to the long-term view we are trying to encourage company directors to focus on. As well as generating profit, business leaders must show awareness of, and commitment to, longer-term stewardship responsibilities, as well as the leadership qualities required to take their workforce with them and drive sustained high performance. The measures used to determine pay of executives and the different reward components should be visible and open to external scrutiny.

9. Regarding narrative reporting, we have always been in favour of a more consistent standard of what is reported, where relevant and necessary information about the health and direction of the organisation not found in the statutory financial reports is given in a way that provides greater insight to all stakeholders. Today the significant majority of value of organisations is tied up in the so called intangible values—human and organisational capital, brand value etc. These are also the areas of value that are most critical to future performance, whereas traditional financial measures point to past performance.

10. We believe that now must be the time to better recognise the importance of human capital to organisational performance and to provide clearer direction and guidance on how information on the human capital of organisations is captured and reported. Previous initiatives such as the Accounting for People taskforce led by Denise Kingsmill in 2003 provided a good base to start from, but the prevailing economic times and political environment did not provide an impetus for take up. Many of the issues we are now confronting on encouraging the right cultures and behaviours, focusing on the issues and measures that really define longer term organisational performance and success have at their root the need to provide more visibility on the human capital and organisational dimensions of business. Providing a framework for reporting and comparing on these dimensions will be critical to providing insight to all stakeholders, including shareholders, and the pressure on management to focus on these longer term variables. This is something that the CIPD in combination with others such as CIMA and the UKCES are determined to make progress on, but will require sponsorship and support from Government.

11. Also crucial to a sustainable, long-term business strategy is investment in future talent pipelines, to ensure an organisation has the skills they need both immediately and for the future. In 2012, the CIPD launched its *Learning to Work* programme, aimed at achieving a shift in employer engagement with young people, so that they are encouraged to help them in entering and remaining in the labour market. As part of this, we encourage employers to adopt a “youth policy”, whereby they offer a wider range of entry routes into their organisations in order to be accessible to wider talent pools. This will not only contribute towards the important goal of driving social mobility, but will also help organisations develop the diverse and dynamic workforces they need to carry them into the future.

12. We welcome the actions taken by the Government following the publication of the final Kay report. We are strongly in favour of higher quality narrative reporting, incorporating strong guidance on human capital reporting, which is simpler and more relevant to its intended audience. In our response to the Department for Business, Innovation and Skills’ consultation on *The future of narrative reporting*, we called for the inclusion of human capital evaluation in company reports. We believe this to be crucial to long-term sustainability and performance because the practice of collecting, evaluating and reporting on these measures should enable better business decision-making for the long term. More generally, companies should be encouraged to be more long-term in their outlook. CIPD is also supportive of measures to remove mandatory quarterly reporting requirements also as a means to shift focus of measurement and incentive to longer term outcomes.

We will now turn to address some of the specific recommendations set out in the Kay Review, focusing on those on which our expertise enables us to comment most fully.

On whether the Stewardship Code should be developed to incorporate a more expansive form of stewardship, focusing on strategic issues as well as questions of corporate governance:

13. The revised UK Stewardship Code of September 2012 already includes strategy, corporate governance and culture within its definition of “stewardship activities”, on which institutional investors are encouraged to publicly disclose their activity with the aim of protecting value for their clients. It is also recommended that investors should consider intervening when they have concerns about the company’s strategy, governance and approach to risks, including those that are social or environmental.

14. However, we would encourage a *greater* focus on the aforementioned subjects in the Code, in recognition of the importance of culture and corporate governance to an organisation’s performance and brand. To date, there has been an insufficient demonstrated appreciation of the importance of issues such as management and leadership, employee engagement and workplace culture (and of corporate governance and culture more widely) amongst business leaders. Whilst we do not believe that culture change can be achieved through legislation, we believe that having clear guidance focused on good practice and outlining the business benefits to be gained from consistently demonstrating the right values in behaviours, communications and actions, will encourage directors and investors to ask more probing questions about a wider range of activities, both internally and externally.

15. A more expansive form of stewardship should entail a focus on employee engagement; we welcomed the launch of the Employee Engagement Taskforce by the Government in 2011 and the Engage For Success initiative in 2012, and will continue to support its aims of driving the value of employee engagement to business and financial performance. Company directors need to take a broader view of what is important, ensuring they operate with strong ethical principles, visibly demonstrating an awareness of the importance of long-term performance measures that go beyond the financial. Internally, starting from the top, directors must ensure they have channels and procedures in place to account for employee voice and challenge, as well as provisions for whistleblowing, to ensure that employees feel comfortable reporting wrongdoing.

16. We would like to stress that a Stewardship model may not be appropriate for all types of business—it might not work for a start-up, for instance. It would be unfortunate if one set of unintended consequences were replaced with another and we would warn the Government against pursuing this outcome too stringently as a “one size fits all” solution.

On whether company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making; and regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review’s Good Practice Statements:

17. We support the development of Good Practice Statements in principle. These will provide non-regulatory, non-binding guidance to company directors and investors on how organisations should be run for the benefit of their clients, employees and business. We favour a “comply or explain” approach to adherence to these statements rather than a hard regulatory approach.

18. The Good Practice Statements in John Kay’s Review rightly require asset managers and holders to operate in the best long-term interests of their client, operate within “a culture of open dialogue” and be transparent in their operations. The Statements also specify that remuneration should not be related to any short-term incentives of performance measures. We would recommend that these should be adopted and existing standards aligned to them.

19. However, we also believe that given the importance of human capital management (HCM) and reporting to the long-term business success of an organisation, this should be actively recommended in Good Practice Statements. Number 9 of the Review’s “Good Practice Statements for Asset Managers” recommends that asset managers be informed by “an understanding of company strategy and a range of information relevant to the specific company”. We believe that this could be developed, made clearer and more specific, in order to “nudge” companies to recognise the value of human capital reporting and act accordingly.

20. We believe that the HR function in particular has an important role to play in driving professional standards and best practice. CIPD is working with the City Values Forum, the Chartered Banker Institute and the City HR Association to promote professional standards in the City. Similarly, our own work as a Chartered institute encourages organisations to operate to a higher standard, incorporating performance against values and behaviours alongside the financial considerations. Within the past year, we have produced research insights into the importance of trust in the workplace, and the exploration of effective leadership models in the current political and economic climate. We have also worked with Business In The Community (BITC) on developing public reporting guidelines that take account of HCM data, and are actively seeking to collaborate more with bodies like CIMA to develop future-focused HCM guidelines.

On whether an investors’ forum should be established to facilitate collective engagement by investors in UK companies:

21. We believe that an investors’ forum would be a useful and valuable way for investors to share ideas and experiences, as well as discuss challenges as and when they arise. The opportunities for collective engagement that arise from information sharing in this way have the potential to be as useful as written public guidelines, and indeed would be complementary to them.

22. The existence of the City Values Forum and the Lord Mayor’s *Restoring trust in the City* initiative is evidence of a wider opinion that the current state of affairs does need to change and move towards a more inclusive understanding of purpose and performance. We encourage the Government to capitalise on this momentum and encourage greater collaboration with these and similar initiatives more widely.

Whether mandatory quarterly reporting obligations should be removed:

23. We support proposals to remove quarterly reporting obligations. We believe that this approach is consistent with the aim of fostering a longer-term approach to the evaluation of an organisation’s activities and performance. Reporting on a quarterly basis is not only quite burdensome for some companies, but may act as a contributory factor to a short-term outlook on company performance.

Whether high-quality, succinct narrative reporting should be strongly encouraged:

24. We are in favour of a high-quality, succinct approach to narrative reporting, with a strong focus on human capital management and other measures that support evaluation of the less tangible dimensions of sustained business performance. Good quality human capital information is crucial to informed decision-making, both internally and externally, in order to support sustainable organisation performance. We believe that the creation of a clear narrative reporting framework to help and encourage more employers to provide meaningful HCM reporting would be a useful step towards, over time, ensuring better-quality people management information is provided to shareholders.

25. HCM has historically been under-valued by investors, as has the importance of good management and leadership to organisational performance. CIPD’s 2006 research, *Investors’ view of human capital*, showed that even where human capital information was collected and analysed, this was too often focused too much on the top team, whilst data on the rest of the organisation was rarely used as the basis for investment decisions. Our

2010 report, *View from the City*, showed a refreshing positive change for the better in investors' views of HCM, but that the pace of change was slow. Crucially, however, there is evidence of stronger agreement around people management as a potential leading indicator of long-term business sustainability.

26. One of the difficulties inherent in using human capital data is that it does not translate easily into hard numbers and statistics, which investors typically feel most comfortable with. However, the increasing realisation that numerical data alone cannot give sufficient information for judgements to be made, and the need to be able to interpret hard data in the right context, may point to the increased use of more qualitative human capital data in recent years.

27. This, in turn, points to the argument that human capital data should be framed more in terms around HR and business risk, rather than in terms more related to social responsibility. Business leaders will inevitably be concerned about factors that stand to influence their productivity and overall profitability. If human capital data is presented in this kind of framework, it will encourage directors and investors to ask different questions about what factors stand to have positive (and negative) effects on their current performance and long-term sustainability.

28. We call on the Government to promote the use of HCM reporting by quoted companies on a voluntary basis. We believe that this position would be strengthened by the publication of good practice examples. Many companies already operate to high standards of narrative reporting, and shining a light onto best practice will clarify to others how high-quality reporting can be done. In response to what we believe to be the poor quality of reporting on HCM, CIPD with Henderson Global Investors supported BITC in producing public reporting guidelines in 2011, with the longer term aim of producing an accessible public reporting template for early 2013. We would be happy to share this with the Committee.

Whether companies should structure directors' remuneration to relate incentives to sustainable long-term business performance:

29. High executive pay and financial rewards for short-term successes (and sometimes failures) have become symptomatic of the destructive culture that pervades certain sectors, where a singular focus on financial gain has been allowed to predominate over consideration for how that growth is achieved. This has also led a tone to be set within certain organisations that encourages rule-bending and unnecessary risk-taking in pursuit of financial and other rewards.

30. Furthermore, this focus on financial gain to the exclusion of other considerations has played a large part in distorting views of businesses' purpose and role within society, resulting in the aforementioned decline in trust in big business. We believe that levels of senior pay should not only be related to longer-term performance measures, but that these performance measures themselves should account for a wider range of aims and objectives—going beyond the purely financial.

31. However, it is important to retain a degree of flexibility and perspective in this debate. In many instances, it would be entirely appropriate to reward short-term success, and we do not advocate that organisations should be dissuaded from doing so in all cases, rather that they should seek to base reward decisions on long-term performance measures and outcomes where possible.

32. We believe that organisations would benefit from clear guidelines (that are not prescriptive), as well as some examples of good practice on ways to manage reward-related risks. Evidence shows that many businesses can find the management of reward and reward risks quite challenging, which suggests the need for guidance that organisations can then tailor to their specific business models.

33. The CIPD's annual *Reward Risks* survey explores how organisations manage reward-related risks as perceived by practitioners and consultants, including strategic, implementation and governance risks. Our October 2012 report showed that the alignment of reward policy to wider business strategy remains as important, yet as nuanced and as challenging, to employers as in previous years. The overall top ten ranking of perceived reward risks include:

- Employees not understanding what is required of them in terms of behavior and performance.
- An inability to change reward practices quickly.

Difficulty communicating desired behaviour and performance requirements to employees.

34. The top concern for reward practitioners and consultants last year, as well as for 2011, was that employees did not appreciate the value of their total reward offering—perhaps unsurprisingly in the context of the communication difficulties many employers are experiencing. Employers also expressed concern that reward packages were not adequately engaging employees at all organisational levels. High pay has traditionally been cited as being necessary to keep “top talent” in an organisation. However, CIPD research, *Employee attitudes to pay*, shows that directors' pay, and the pay of other senior figures in an organisation, has the potential to affect levels of employee engagement and satisfaction lower down the organisation as well.

35. The idea that a reward package might not be seen as fair is another key concern for reward professionals and practitioners, featuring in our *Reward Risks* top ten ranked list of concerns for the past three years. Particularly during difficult financial times, the question of the distribution of pay throughout an organisation

will arise more frequently as lower-paid employees feel the pinch. The CIPD's *Employee attitudes to pay* report series examines employer pay decisions across the sectors and employee reactions to these. Our January 2013 report showed that many employees feel that senior managers and leaders are paid too much for what they do, whilst they themselves are undervalued by their organisation.

36. It is crucially important for organisations to acknowledge the importance of how their employees, as well as Boards and external stakeholders, are feeling about issues such as top-level pay and how it relates to their own remuneration. If employees believe that their employer is being inconsistent in their approach to remuneration at top and bottom, there is a real risk that this might cause disengagement with their jobs and their organisation, becoming less engaged with the collective endeavour. Organisations stand to suffer if their CEOs are not seen to regard themselves as stewards of the enterprise who are interested in long-term, sustainable success, and instead come across as being focused only on the short-term outlook, their career development and pay trajectory.

CONCLUDING COMMENTS

37. Notwithstanding the importance of financial considerations to businesses of all sizes, and the role of remuneration in recruiting and retaining talent, we see the greatest challenge following the Kay Review and the Committee's inquiry as that of widening perception beyond the realms of the financial, to take account of the importance of other factors that contribute to business success and sustainability.

38. The evidence, both from CIPD and other bodies, is that issues surrounding organisational and workplace culture, investment in skills and talent development, employee engagement, fair and open performance management and reward practices, and appropriate corporate governance, are what makes the difference to a business' long-term sustainable performance. The biggest issues are not only the financial considerations but how a company operates, whether it is seen externally to adhere to high ethical standards, and whether it demonstrates responsibility to both its internal and external stakeholders. The greatest contribution the Kay Review and the Committee can make to the future of UK business behaviour is to acknowledge this and to ensure that organisations themselves act accordingly.

22 January 2013

Written evidence submitted by UK Sustainable Investment and Finance Association (UKSIF)

SUMMARY

1. UKSIF welcomes the Committee's decision to conduct their inquiry; we are pleased to note that the issue of long-termism is attracting attention from a wide variety of industry, political and civil society stakeholders.

2. Our response focuses on: the role of asset owners and companies in boosting long-term investment; the need to integrate environmental and social (as well as governance) factors into decision-making; the role of the Government in ensuring stable regulatory and policy frameworks; and the importance of the Stewardship Code.

3. We agree with Professor Kay's analysis and conclusion that not only is short-termism a problem in UK equity markets, but that the principal causes are the "decline of trust and the misalignment of incentives throughout the equity investment chain".

4. This submission draws on feedback from discussions with our members and our previous submissions to the Kay Review, the Financial Reporting Council's consultation on proposed changes to the Stewardship Code (July 2012) and the Labour Party-commissioned Cox Review (August 2012).

ABOUT UKSIF

5. The UK Sustainable Investment and Finance Association (UKSIF) supports the UK finance sector to be a global leader in advancing sustainable development through financial services. We promote and support responsible investment and other forms of finance that advance sustainable economic development, enhance quality of life and safeguard the environment. We also seek to ensure that individual and institutional investors can reflect their values in their investments.

6. UKSIF was created in 1991 to bring together the different strands of sustainable and responsible finance nationally and to act as a focus and a voice for the industry. UKSIF's 250+ members and affiliates include pension funds, institutional and retail fund managers, banks, financial advisers, research providers, consultants and NGOs. For more information about UKSIF, please visit www.uksif.org.

THE KAY REVIEW

7. Responsible investors as a group have been among the first to consider the risks and opportunities from long-term social and environmental challenges. Leading practitioners have a particularly strong understanding of the market failures which sometimes prevent investors from translating this knowledge into investment decision-making.

8. We agree with Professor Kay's analysis of the shortcomings of the current structure of equity markets in promoting long-term decision-making, particularly the short-termist culture and practices across the investment chain and the underlying problems with trust and business relationships.

9. UKSIF also supports his approach to finding a solution to the problem of short-termism by setting out high-level principles to guide the regulation of equity markets. We particularly support his focus on defining and expanding the principles of stewardship.

10. We feel that both Professor Kay's analysis and his set of 10 guiding principles make an important contribution to the debate on long-termism; we hope that both Government and industry will take these principles forward.

11. We also believe that many of Professor Kay's recommendations could have a significant long-term impact on how shareholders engage with companies including:

- *Clarifying the concept of fiduciary duty*: Recent research has shown that in principle, long-term decision making is consistent with legal obligations but trustee concerns remain.
- *Encouraging high-quality, succinct narrative reporting*: We know from our members that investors require forward-looking business-relevant strategies and metrics, not simply boilerplate text. There are currently moves at a global level to support better-quality "integrated reporting" which supports value creation over time.
- *Improving the quality of engagement by investors with companies*: UKSIF members tell us that mandates, investment management agreements and scrutiny by asset owners are all effective tools in driving long-term approaches in the investment chain.
- *Restructuring directors' remuneration to relate incentives to sustainable long-term business performance*: We were pleased to see that BIS undertook consultations on narrative reporting and executive pay, in addition to commissioning the Kay Review. However, we still feel that the government has yet to facilitate a deep and constructive debate specifically on incentives and pay within the investment chain beyond these consultations.

12. Although we understand the need for any Government review to have a focused remit, we also feel that there were some areas relevant to encouraging long-term decision-making that we feel would have benefited from further examination.

The role of asset owners and companies in promoting long-term investment

13. The Kay Review Final Report focused largely on how to encourage asset managers to better think and act for the long-term as opposed to purely "managing short-term earnings expectations". While the role of intermediaries is important in promoting long-term investment, we believe it is not the whole story.

14. It is asset owners who are best positioned to drive change by incentivizing their managers to invest over a longer horizon than most currently do; genuine demand from pension funds and other asset owners could create commercial drivers for long-term investment practice and it has been a recurring theme amongst the feedback from our asset manager members that it is easier to justify effective implementation of, for instance, the Stewardship Code or the UN-backed Principles of Responsible Investment, if there is a commercial incentive to do so.

15. The need to boost asset owner demand for sustainable investment practices has also been highlighted by the Financial Reporting Council in their December 2012 publication *The impact and implementation of the UK Corporate Governance and Stewardship Codes*⁵⁹. Meanwhile, our most recent *Sustainable Pensions 2011* survey⁶⁰ found some excellent examples of best practice among pension funds but many more could do with following their lead.

16. We also feel that the Kay Review insufficiently examined the role of companies in encouraging "long-termism" in the investment chain through their influence on corporate pension funds, employees and other stakeholders. For instance, our *Sustainable Pensions 2011* survey suggested that plan sponsors would have influence if they encouraged their corporate pension funds to require long-term responsible investment approaches. We would also support an approach by companies to educate employees, customers and suppliers about the value of long-term investment practices.

17. In order to boost demand by asset owners and companies for long-term investment practices, UKSIF will be organising the UK's first "Ownership Day" on the 12 March 2013, a national campaign which aims to increase awareness and understanding of active long-term asset ownership and underline how it can protect the value of assets.

18. Our additional recommendations for Government include:

- *Ensuring that UK policymakers act as role models for responsible investment.*

⁵⁹ www.frc.org.uk/getattachment/47293b70-bd65-485c-bbcd-d9a63688b87d/Developments-in-Corporate-Governance-in-2012.aspx

⁶⁰ <http://uksif.org/wp-content/uploads/2012/10/UKSIF-Responsible-Business-Sustainable-Pension-2011.pdf>

- UK policymakers could act as leaders in responsible investment practices; for instance, the government could require all Local Government Pension Scheme funds to drive effective long-term approaches through their purchasing of investment services; Similarly, the UK Parliamentary Contributory Pension Fund (PCPF) could sign up to the Stewardship Code.
- *Improved co-ordination between The Pensions Regulator (TPR) and other regulators on the Stewardship Code.*

UKSIF have always believed that the Stewardship Code must harness the role of asset owner demand for good stewardship from their investment managers; we feel that there should be greater involvement by the TPR to encourage adoption of the Code throughout the investment chain.

ENSURING STABLE REGULATORY FRAMEWORKS THAT DRIVE LONG-TERM COMPETITIVENESS

19. We feel that there is a clear role for Government to play in ensuring that regulators and policymakers in or under the oversight of other departments in addition to BIS, such as the Treasury and the Department for Work and Pensions, act in a co-ordinated fashion to reform equity markets.

20. There is also a need for long-term policy stability when it comes to setting the framework for investment opportunities; Government policy has most potential to influence investors and corporate boards to focus on the long-term through its regulation of externalities—such as its policies on climate change. Unanticipated policy changes can damage investor confidence and their willingness to invest for the long-term.

THE GOVERNMENT RESPONSE

21. UKSIF welcomed the Government's response to the Kay Review Final Report and were pleased that it recognised the relevance of Professor Kay's analysis. We also welcome the Government's decision to organise a Progress Review for summer 2014 as we think this could be a promising signal of their commitment to driving forward Kay's recommendations.

22. We hope that there will be a move towards some form of cross-departmental work on stewardship including discussions with the Treasury as well as regulators like The Pensions Regulator and the FSA (and its successor bodies). We feel this would play an important part in spreading good stewardship practices across the investment chain.

Caroline Escott
Programme Director & Head of Government Relations
 22 January 2013

Written evidence submitted by Tomorrow's Company

ABOUT TOMORROW'S COMPANY

1.1 Tomorrow's Company is a London based global think tank delivering value for business leaders and owners by addressing the systemic questions of the business world through the overarching themes of: leadership and talent; sustainability and models of business success and governance and stewardship.

1.2 Our solutions are by business for business, built on deep relationships with business leaders, government, opinion formers and the media.

- Our work informs company law, creates international frameworks and shapes today's business landscape in the UK and globally.
- We defined the inclusive duties of directors for The UK's Company Act 2006.
- Our work on capital markets informed the creation of the UN PRI.
- Our thought leadership on ownership and asset classes is at the heart of the UK Stewardship Code.
- Our work on reporting is at the heart of Europe's move towards narrative reporting.
- King III in South Africa acknowledges our influence.

1.3 Tomorrow's Company has a long-standing relationship with BIS and has contributed to the reform of company law, the review of the combined code, the development of corporate reporting (including narrative reporting) and the creation of the stewardship code.

1.4 In March 2010, with the encouragement of and participation of BIS, Tomorrow's Company established the GGF, which brings together a number of key businesses, organisations and individuals to explore what good governance means and to make practical recommendations to company boards and policy makers. The forum is developing a series of guides and toolkits for use by chairs, boards and advisors, to help achieve practical improvement and change.

1.5 A meeting was held on in November 2011 with representatives from BIS, leading to a joint response by Tomorrow's Company and The Good Governance Forum was submitted to The Kay Review.

1.6 Tomorrow's Company welcomes this Committee's inquiry into the Kay Review of UK Equity Markets and Long-Term Decision Making and the Government's Response to that Review.

2 OUR RESPONSE

2.1 Tomorrow's Company welcomes the recommendations set out in the Kay Review and the Government's plans for the implementation of its recommendations, many of which Tomorrow's Company has argued for in its work.

2.2 In particular, we have been arguing that the financial crises are a result of a systemic failure—not only a failure of individuals and particular companies and institutions. Issues such as:

- investor short-termism;
- the stewardship deficit;
- the dysfunctional nature of the long investment chain (that links the saver at one end to the investee company at the other, a chain that is presently far too heavily influenced by intermediaries);
- the focus on quantity rather than quality of reporting;
- the current understanding and application of fiduciary duty;
- lack of alignment of incentives across the investment chain to the interests of beneficiaries; and
- all play their part.

2.3 It is therefore critical to understand the system as a whole and that any lasting solutions need to move beyond blame and a view that reform can be achieved by a series of piecemeal interventions.

2.4 Structural and process change is necessary but not sufficient to achieve change in the system. Culture and values both drive and inform behaviour across the system. In this respect we would highlight the work of The City Values Forum, supported by the Lord Mayor, aimed at enhancing the City's reputation for integrity and high ethical standards. As part of this initiative, Tomorrow's Company, in conjunction with the Good Governance Forum has been asked to undertake work on 'Governing Values' focused on the role of the board in overseeing the embedding of corporate values which are aligned to the business's long-term strategy, and in ensuring that management promotes and embeds such values consistently all the way through the business.

2.5 In support to the proposals of the Review's proposals, we would suggest the following.

2.6 STEWARDSHIP

- Stewardship is needed throughout the system—by pension trustees, investment consultants, asset managers, company directors, and regulation is needed to ensure all of the above are governed by consistently framed fiduciary duty.
- To assist we have developed four key principles of stewardship:
 - “Setting the course” deals with purpose, roles, and relationships.
 - “Driving performance” is about continually stimulating improved performance and capability.
 - “Sensing and shaping the landscape” is about how the company anticipates and influences change in its surrounding environment.
 - “Planting for the future” reflects the need for consistency between short-term actions and long term success.

(See: Tomorrow's Owners: Defining, differentiating and rewarding stewardship.
www.tomorrowcompany.com/tomorrows-owners-defining-differentiating-and-rewarding-stewardship
)

- These principles underpin the Tomorrow's Company Stewardship Manifesto which offers an agenda for change, and identifies the part that each participant can play in creating an effective stewardship value chain *See: Tomorrow's Company Stewardship Manifesto*
www.tomorrowcompany.com/stewardship-manifesto)
- As part of the Investor Stewardship Working Party, we have developed a 'stewardship framework' against which institutional investors can categorise themselves to help asset owners compare the stewardship activities of different fund managers and so make informed decisions. (*See: 2020 Stewardship: improving the quality of investor stewardship*
www.tomorrowcompany.com/2020-stewardship-improving-the-quality-of-investor-stewardship-the-report)

2.7 GOVERNANCE

- Boards to be more confident in ensuring that they are crystal clear about their own long-term view as the best way of achieving success and managing risk in these conditions of rapid change and growing uncertainty—and then setting out their strategy and communicating this effectively to investors. They should actively seek out the investors that they want. To assist them in doing this, Tomorrow's Company and the Good Governance Forum argue that boards should create a board mandate. This mandate captures the “essence” of the “character” and distinctiveness of the company, in terms of: its essential purpose; its aspirations; the values by which it intends to operate; its attitude to integrity, risk, safety and the environment; its culture; its value proposition to investors; and plans for development. It is about what the company stands for and how it wishes to be known to all of its stakeholders.

(See: Tomorrow's Corporate Governance: The case for the “board mandate”

www.tomorrowscompany.com/tomorrows-corporate-governance-the-case-for-the-board-mandate)

- Corporate reporting plays an essential role in the effective functioning of the market economy, enabling shareholders and investors to assess the performance of a business across all aspects of activity, establish its value and exercise effective oversight. Whilst there are many regulatory and market initiatives and consultations in various parts of the world focused on different aspects of reporting and of the reporting system there is a danger of overload. While these consultations are all well-intentioned, the very fact they are addressing separate elements of the model and the system is indicative on a lack of understanding of how the system operates, its interdependencies, and most critically, how proposed actions will impact on behaviours. The proposals for narrative reporting—which we strongly welcome and have long argued for—need to be framed in a context which reinforces this coherence of approach by recognising the systemic nature of the corporate reporting system and the place of the specific reform in that wider context.

(See: Tomorrow's Corporate Reporting: a critical system at risk [www.tomorrowscompany.com/](http://www.tomorrowscompany.com/tomorrows-corporate-reporting-a-critical-system-at-risk-2)

[tomorrows-corporate-reporting-a-critical-system-at-risk-2](http://www.tomorrowscompany.com/tomorrows-corporate-reporting-a-critical-system-at-risk-2))

2.8 INCENTIVES

- There is a lack of alignment between incentives, the interests of beneficiaries and business strategy. The criteria on which performance and hence reward is based are still too often founded on financial and market value based measures. In part this is a reflection of the lack of knowledge, understanding, common language and metrics about what drives sustainable performance. Discussions about sustainability often default to ESG, SRI, the “green agenda” or are simplified to discussions about long-term versus the short-term horizons.
- For outsiders, it is hard to obtain detailed information on how incentives are structured and designed—there is a lack of transparency. Financial incentives do not operate in isolation—neither are they the only incentives for those in the system. Reputation, personal success and security, organisational values and culture, regulation, fiscal policy and reporting models, all play their part.
- In our work on Tomorrow's Capital Markets, we found that there is a growing appetite for change by many who have deep and long experience of working in the system. We have set out an agenda for change, encompassing a set of principles for the structure of financial remuneration so that capital markets can better support companies to achieve more sustainable outcomes. We are in the course of developing a follow-up phase which will focus on designing new incentive structures as well as looking at what is needed to create the necessary framework conditions for these incentives to operate effectively and also to ensure greater stability of the system as a whole.

(See: Tomorrow's Capital Markets

www.tomorrowscompany.com/tomorrows-capital-markets-2)

2.9 REGULATION

- In our current project: “Tomorrow's Value: Achieving sustainable financial returns” we are exploring how we can redefine value in order to ensure sustainable financial returns and a more balanced approach to investment. This includes understanding the behavioural pressures and fiduciary issues which can lead short-term thinking and investment decisions by pension fund trustees and aims to provide them with fit for purpose evidence and some practical support.
- Our research to date endorses the view that fiduciary duty is not well understood by pension fund trustees and needs to be appropriately and more widely interpreted. Trustees can then feel more confident in implanting their wider views of value into their investment mandates, allowing for a more risk adjusted investment portfolio and sustainable financial returns.
- As behavioural pressures on the pension fund trustees are numerous, systemic and powerful, a better understanding may not be enough.
- Following consultation with a number of key players in the UK pension fund system and across Europe, the case can be made for strengthening the Statement of Investment Principles, through an appropriate intervention to encourage and support pension fund trustees in setting out on a comply or explain basis the criteria that inform the mandate that they set.

To conclude, we welcome the Committee's inquiry into the Kay Review of UK Equity Markets and Long-Term Decision Making and the Government's Response to that Review and also welcome many of the proposals outlined. Our major disagreement with the Kay Report lies in its excessive focus of on the role of the asset manager at the expense of the asset owner. The key point is that this complex system can only be reset with asset owners playing the role that they are required to play.

We would be happy to discuss any of the aspects of our response in more detail.

22 January 2013

Written evidence submitted by the Investment Management Association⁶¹

EXECUTIVE SUMMARY

ES.1. The asset management industry plays a vital role in allocating capital from those that want to invest to those that need investment capital. This is important to the achievement of the Review's vision in creating growth and jobs, and whilst much is said about the loss of trust in the intermediation of the markets, the UK asset management industry remains strong. It saw a 5.1% increase in assets under management in the year to December 2011 from 2010, and 23% from 2009⁶².

ES.2 As an agent, an asset manager has a fiduciary responsibility to its clients, as well as responsibilities derived both from contractual agreement and regulation. Combined with fee structures, these elements help to ensure that the manager acts in the client's best interest. In this context, IMA supports stewardship—it is important for ensuring good outcomes for clients. Our members are increasingly pursuing good corporate stewardship in achieving better outcomes. However, an asset manager acts as an agent for its clients and we do not support such matters being prescribed such that the terms of asset owners' mandates with managers are constrained. Moreover, while long-term holdings will tend to form a core part of portfolios, holding periods for individual stocks and securities will inevitably vary. The important thing is that asset managers continue to deliver value for their clients. Nor do we consider an asset owner should be ascribed a societal role in determining the terms of their mandate.

ES.3 We set out below our evidence on Kay's Recommendations and the Government's Response. In places we distinguish between "fund managers" operating pooled funds such as UK Authorised Funds (unit trusts and open-ended investment companies) which pool money from many clients in the same vehicle; and "investment managers" that have discretionary management of assets for individual clients according to segregated mandates. We refer to the two together as "asset managers".

Recommendation 1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance

1.1 IMA supports this Recommendation and, as noted in the Government's response, it has already been addressed in the Financial Reporting Council's revised edition of the Stewardship Code which was published in September 2012 and came into effect on 1 October 2012.

1.2 Over the last three years, with a steering group chaired by the FRC, IMA has looked at institutional investors' activities that underlie their policy statements drawn up under the Code. Our first report looked at the position as at 30 September 2010⁶³, our second to 30 September 2011⁶⁴ and we plan to issue our third to 30 September 2012 in the first part of this year.

1.3 The second report summarised 83 responses to a questionnaire sent to 173 signatories as at 30 September 2011. The 58 asset managers that responded managed £774 billion of UK equities, representing 40% of the UK market, and the 20 asset owners owned £62 billion (five Service Providers also responded but do not manage or own equities for investment purposes).

1.4 To gain a better understanding of the issues that give rise to engagement, respondents were invited to indicate the number of companies they engaged with on particular issues. This demonstrated that a company's strategy and objectives are clear priorities in that respondents engaged with 1,611 companies on these issues. This compares to more conventional corporate governance matters and engagement with 1,754 companies on remuneration issues (these are subject to a specific vote) and 1,039 companies on board diversity/committee membership. A similar ranking is evidenced in the third draft report which is still being collated.

⁶¹ IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of approximately £4.2 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (eg pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, the Annual IMA Asset Management Survey shows that IMA members managed holdings amounting to 34% of the domestic equity market.

⁶² Page 14, Asset Management in the UK 2011–2012, the IMA Annual Survey. <http://www.investmentfunds.org.uk/research/ima-annual-industry-survey/>

⁶³ <http://www.investmentfunds.org.uk/research/stewardship-survey>

⁶⁴ <http://www.investmentfunds.org.uk/assets/files/surveys/20120612-stewardshipcode.pdf>

1.5 Moreover, in seeking to establish a mechanism for collective engagement (see press release at <http://www.investmentfunds.org.uk/press-centre/2012/press-release-2012-11-22>) one of our premises is that intelligent engagement with companies on strategy can help secure better long-term sustainable returns for shareholders. Governance and remuneration issues are important in so far as they underpin the achievement of that strategy (see Recommendation 3 below).

Recommendation 2. Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements

2.1 IMA supports market-led solutions and in principle, the proposed Good Practice Statements for asset managers, asset owners and company directors seeking to emphasise the need for trust-based relationships.

2.2 However, many of the points in the proposed Good Practice Statement for asset managers are already addressed in regulation. For example, all regulated firms are subject to the Financial Services Authority's "11 Principles" which include requirements to:

- conduct business with integrity, and due skill, care and diligence;
- pay due regard to clients' interests and treat them fairly;
- pay due regard to clients' information needs and communicate information which is clear, fair and not misleading;
- manage conflicts of interest fairly, both between the firm and its clients, and between individual clients; and
- take reasonable care to ensure the suitability of advice and discretionary decisions for any client that is entitled to rely on the firm's judgment.

It is also a European requirement, first implemented in the FSA Handbook from 1 November 2007, that asset managers must act honestly, fairly and professionally in accordance with the best interests of their clients (and now in the case of a fund manager, the fund it manages). These requirements largely address the first three points in the Statement.

2.3 Other rules provide greater specificity in particular areas. For example, as regards "adhering to the investment strategy agreed with clients",⁶⁵ suitability requirements⁶⁶ seek to ensure an asset manager obtains information to understand the essential facts about their client and has a reasonable basis for believing that transactions in the course of managing that client's assets meets the client's objectives.

2.4 Specifically, the information on a client's objectives must include, where relevant, the length of time the client wishes to hold the investment, their attitude to risk and risk profile, and the purpose of the investment. A client's, the asset owner's, time horizons, investment objectives and strategy may vary. Thus an asset manager may not be able necessarily to prioritise "medium to long-term value creation and absolute returns"⁶⁷ and make "investment decisions based on judgments about long-term company performance".⁶⁸ It is not a given, for example, that an asset owner wants an absolute return investment objective.

2.5 Similarly as regards asset managers building an "on-going relationship of stewardship with the companies they invest",⁶⁹ it is an FSA Conduct of Business requirement that asset managers (with professional clients) have a statement of their commitment to the FRC's Stewardship Code or explain their alternative strategy.⁷⁰ This, and the "comply or explain" approach to the Code itself, recognises the agency nature of asset management and that as fiduciaries acting on behalf of clients, managers offer a choice. In operating in the best interests of its clients, see 2.2 above, an asset manager may want to divest a holding if clients' interests cannot be protected through stewardship and we are concerned that it is often implied that asset owners and managers have a societal role that requires them to engage with companies.

2.6 Moreover, both long-term value creation and stewardship are more immediately relevant to equity markets. Both asset managers and asset owners will have market exposures far wider than equities and which are international.

⁶⁵ Point 6 in the Good Practice Statement.

⁶⁶ Financial Services Authority Conduct of Business Rule 9.2.1, (1) firm must take reasonable steps to ensure that a personal recommendation, or a decision to trade, is suitable for its client. (2) When making the personal recommendation or managing his investments, the firm must obtain the necessary information regarding the client's: (a) knowledge and experience in the investment field relevant to the specific type of designated investment or service; (b) financial situation; and (c) investment objectives; so as to enable the firm to make the recommendation, or take the decision, which is suitable for him.

⁶⁷ Point 7 in the Good Practice Statement.

⁶⁸ Point 9 in the Good Practice Statement.

⁶⁹ Point 8 in the Good Practice Statement.

⁷⁰ Financial Services Authority Conduct of Business Rule 2.2.3 which was effective from 6 December 2010. This requires that an asset manager acting for a professional client that is not a natural person must disclose clearly on its website, or if it does not have a website in another accessible form: (1) the nature of its commitment to the Financial Reporting Council's Stewardship Code; or (2) where it does not commit to the Code, its alternative investment strategy.

2.7 Care, therefore, is needed to place Good Practice Statements⁷¹ into their appropriate context and in ensuring that they are not unduly constraining for asset owners and asset managers, and the terms of any agreed mandate. Notwithstanding this, IMA has been a long-standing supporter of the stewardship agenda and our members are increasingly pursuing considered corporate stewardship in achieving better outcomes for clients. We set out in Annex 1 how this role has been transformed over the last decade. We are also a member of the Institute of Chartered Secretaries and Administrator's steering group referred to in the Government's response.⁷² This is developing a good practice guide to improve the quality of engagement and aims to identify more effective means for companies and institutional investors to provide feedback on meetings.

Recommendation 3. An investors' forum should be established to facilitate collective engagement by investors in UK companies.

3.1 IMA agrees that it may be helpful to establish an investor forum or mechanism to facilitate collective engagement. Whilst we recognise there are already a number of ways in which groups of investors come together, we believe there may be a need for a mechanism, which is open to the broadest possible range of shareholders in a particular company to take collective action, in instances when individual engagement has failed. We believe it important that any such initiative is investor/shareholder led and are currently engaging with the investment community in completing a series of meetings in order to determine the best means of taking this forward. We are also keeping BIS officials up-to-date with developments.

3.2 Whilst we have certain ideas, we want an open discussion in order to be able to develop a solution that will be effective and which is supported—see Annex 2. We believe that any solution should elevate the importance of investor understanding and engagement with a company's strategy for the delivery of sustainable, long-term shareholder value. Wider governance and remuneration issues are important in so far they underpin the achievement of that strategy. Some of the issues that have been identified to date during our discussions include:

- any mechanism to be effective needs to ensure, either through a Code of Conduct and/or Non-Disclosure Agreements, that discussions are kept confidential;
- concerns about the creation of price sensitive information with the concomitant trading restrictions need to be addressed; and
- concert party concerns which appear particularly to be an issue for US investors.

3.3 As noted, we want any such mechanism to be investor-led, but, if sufficient support can be secured, we are committed to providing it with resource and funds as necessary. We are discussing our proposals with other trade associations, such as the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF), and are including them in our meetings with investors and keeping them up-to-date with our thinking as it develops.

Recommendation 4. The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves

4.1 This is outside IMA's remit.

Recommendation 5. Companies should consult their major long-term investors over major board appointments

5.1 In principle, IMA agrees that companies should consult their major investors over major board appointments. In the main this already happens and investors welcome it particularly when a company is considering changes at a time when the company concerned is in difficulty or to key roles such as chairman or chief executive. But we do not believe investors or companies necessarily want to be consulted on every appointment or that this should be mandatory—neither has the resource to do so and it could undermine the role played by the nominations committee. We also question what is meant by “long-term” investors. Asset managers provide their clients with an investment service and adopt varying strategies to meet specific mandates. While long-term holdings will tend to form a core part of portfolios, holding periods for individual stocks and securities will inevitably vary.

5.2 In the event a company makes an appointment that investors do not believe is appropriate, each new appointment has to be ratified at the Annual General Meeting and it is a provision of the UK Corporate Governance Code that all directors of FTSE 350 companies are subject to annual re-election by shareholders.⁷³

5.3 Moreover, when signatories to the Stewardship Code indicated the number of companies they engaged with on particular issues, see paragraph 1.4 above, executive remuneration and company strategy/objectives, were closely followed by board diversity/committee membership (1,039 companies).

⁷¹ Points 4, 5, 10 and 11 in the Good Practice Statement repeat Recommendations 8, 10, 3 and 16, respectively. Our observations are set out under the relevant Recommendation.

⁷² Page 19.

⁷³ Provision B.7.1. B.7.1 and B.7.2 also expect the papers accompanying a resolution to elect or re-elect directors to set out the following: sufficient biographical details to enable shareholders to take an informed decision; why they believe an individual should be elected; and on re-election confirmation that, following formal performance evaluation, the individual's performance continues to be effective and demonstrates commitment.

Recommendation 6. Companies should seek to disengage from the process of managing short term earnings expectations and announcements

6.1 As set out under Recommendations 11 and 15, quarterly reporting and executive remuneration structures, respectively, can result in too much focus on the short-term meaning that companies can lose sight of their long-term objectives for development of the business and can result in value destruction. We consider these matters should be addressed.

Recommendation 7. Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.

7.1 We do not consider the proposed new standard is needed given existing regulation (of which much is at EU level). We set out at Annex 3 our paper on the relationship between fiduciary duty, contract and regulation that we submitted to Government (this addresses segregated mandates). As we explain in this paper and our submissions to the Kay Review, we do not consider that existing regulation acts as an impediment to asset managers using a long-term approach where the client expresses such an objective.

7.2 Even if there could be a restatement of fiduciary obligations consistent with EU law, IMA considers that the current rules impose very high standards. It is still unclear to us what is deficient with the current requirements for asset managers; if trustees are fearful of suit or the law applying to them is unclear, then that is a different issue. The investment manager's role is to follow the mandate it is given by the client; the fund manager to follow the objectives of the fund prospectus.

7.3 We do not see the need for the UK to move away from the EU standard, even if it could make a case to do so. Additionally, and without prejudging any Law Commission work—see Recommendation 9 below—we do not consider it would be sensible from the viewpoint of the UK's competitiveness to prohibit contractual modification of a range of, sometimes disputed, statements of fiduciary responsibility, developed through case law in many areas of business. It is essential that services can be tailored to the needs of global investors serviced from the UK, especially where the investor concerned has no interest in UK equity investment. Annex 3 explains our position.

Recommendation 8. Asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund

8.1 The asset management industry is committed both to high standards and consistency of disclosure. Detailed parameters for disclosure by investment and fund managers of charges for services (including performance fees) and transaction costs incurred in delivering those services are set out in both regulatory requirements and industry codes and guidance. We set out below the requirements for investment managers' segregated mandates and fund managers' pooled funds.

SEGREGATED MANDATES

8.2 Disclosure to one of the most significant client groups using segregated mandates, occupational pension schemes, is covered by the IMA's Pension Fund Disclosure Code. This was first produced in 2002 by a group of investment managers, pension fund trustees and investment consultants, and has been endorsed by the NAPF's Investment Council.

8.3 The Code's objective is to promote investment managers' accountability to clients through increased transparency and to assist pension fund trustees' understanding of the charges and costs levied on the fund's assets for which they are responsible. It provides a comprehensive, clear and standardised form of disclosure that allows trustees and their advisers to monitor and compare all costs incurred during the management of their fund's assets.

8.4 The Code has been updated twice, in 2005 and 2007, to accommodate disclosure requirements under the FSA's Use of Dealing Commission regime, and also to bring it into compliance with the execution provisions of the Market in Financial Instruments Directive 2004/39/EC (MiFID). It operates on two levels.

- Level 1 is a description of house policies, processes and procedures in relation to the management of costs incurred on behalf of clients and, in respect of new provisions brought in by MiFID, appropriate information on the investment manager's execution policy. This is particularly relevant for the disclosure of implicit costs where they cannot be measured accurately eg transaction costs.
- Level 2 is client specific information. This requires disaggregation of transactions by counterparties and disclosure of commissions on those transactions and services received in exchange for those commissions. Additional commentary is provided where this helps put numerical disclosure into context. It also requires managers to disclose, in percentage terms, the firm-wide pattern of trading, and the sources and uses of commissions overall in the relevant asset class and to compare that to the specific client.

In addition, Level 2 requires disclosure of other costs eg fund management fees and other income derived by the manager and associates, underwriting/sub-underwriting commissions, stock-lending income to the fund and the associated fees, VAT, stamp duty and any other transaction taxes and levies.

8.5 The latest version of the Code is at: *Pension Fund Disclosure Code—September 2007*.

POOLED FUNDS

8.6 A version of the Pension Fund Disclosure Code applies to pooled funds that are UK Authorised Funds. This is the CIS Disclosure Code, jointly issued by the IMA and the Depositary and Trustee Association (DATA), and is intended to provide a similar level of accountability and transparency with respect to transaction costs to that provided by the Pension Fund Disclosure Code. However, the CIS Code is not a consumer document, but intended to be used by fund trustees and depositaries with specific oversight responsibility for Authorised Funds. It is available on request.

8.7 The majority (around 85% of total funds under management) of UK Authorised Funds are regulated under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directives. These are governed by the Key Investor Information Document (KIID), which ensures that charges (including performance fees) are disclosed in a transparent and consistent manner. The KIID does not cover transaction costs, which have traditionally been disclosed in a fund's report and accounts which are available to all investors. However, IMA considers that for retail investors in particular, there is a need to make transaction costs more accessible. After consultation, IMA issued Enhanced Disclosure Guidance in September 2012, which both addresses the accessibility of transaction cost data and aims to achieve greater consistency in charge disclosure. The latest version is at: *Enhanced Disclosure Guidance*. IMA is also supporting work in the pensions industry seeking to develop greater consistency of disclosure both for workplace scheme decision-makers and for consumers.⁷⁴

8.8 Some have suggested that charges and transaction costs should be combined into a single number. IMA strongly disagrees with this and believes a single metric would be misleading since charges and costs are fundamentally different and behave in different ways. Charges are paid for a service undertaken on behalf of an investor. Transaction costs (including taxes such as stamp duty) are necessarily incurred in the management of the portfolio in delivering the investment objectives. They are not paid to a manager, but arise when buying and selling investments in the market.

8.9 For example, take two equity funds—Fund A has an on-going charge of 0.5% and turns over 10% of its portfolio during a one year period. Fund B has an on-going charge of 0.5% and turns over a quarter of its portfolio over the same period. Which is more expensive? In reality, both charge the same for the service, but only the performance will tell you whether the transaction costs had a positive result on the final outcome. A manager cannot hide from poor performance and a poorly performing fund manager will receive lower income via ad valorem charges—there is no incentive to over-trade to the detriment of performance.

8.10 In summary, IMA believes that both charge and transaction cost information should be readily available to investors to help them understand what they paying a manager and the manager's costs in providing that service. Combining figures would not be meaningful.

Recommendation 9. The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers

9.1 Asking the Law Commission to undertake such a review will mean that it will be subject to an open and transparent consultation process. We welcome this approach and the opportunity to provide input. In this respect, the Law Commission undertook sound work on fiduciary duties in financial services in the mid-1990s.

Recommendation 10. All income from stock lending should be disclosed and rebated to investors

10.1 Stock lending generates incremental returns for portfolios contributing to the overall investment performance. IMA supports consistent transparency of stock lending and the associated income to end-investors so that they have a clear view of the revenue earned and the amount retained by the lending agent. Indeed, in 2005, IMA introduced accounting requirements under which managers of UK Authorised Funds were required to disclose the gross amount of fee revenue generated from stock lending, in addition to the amount received by the fund, the value of stock on loan and the nature and value of collateral held as security. However, we do not agree that all income should always be rebated.

10.2 Stock lending seeks to minimise the potential risks to the end-investors in that multiple counterparties are used, there is over collateralisation and contractual indemnification against losses from borrower default. These activities come with a cost to the lending agent—counterparties and collateral parameters are continuously reviewed, and settlement and corporate actions monitored. The lending agent provides trading expertise, economies of scale and risk controls across all clients that lend their stock. Moreover, whilst a high

⁷⁴ This work has involved both the NAPF, which has now published a joint industry code on disclosure to employers, and the ABI, which is currently considering how to improve consumer disclosure.

proportion of stock lending is through automated programmes, these require significant investment in systems and technology.

10.3 The model established by end-investors and the stock lending industry is that the lending agent receives a percentage of gross revenues to cover the costs of the service. The agent is only compensated if revenue is generated and thus the end-investors' interests are aligned with those of the lending agent.

10.4 UK Authorised Funds have been permitted to conduct stock lending only on the basis it represents no or minimum risks for investors in these funds. This risk to end-investors is minimised by Regulation which requires full collateralisation of exposures with highly liquid assets.

Recommendation 11. Mandatory IMS (quarterly reporting) obligations should be removed.

11.1 IMA supports this Recommendation and the fact that the existing EU requirement for interim management statements is being removed. There is a broad consensus in the UK that the re-introduction of a quarterly reporting requirement would be unhelpful on the basis that it can incline companies to focus on the short term.

Recommendation 12. High quality, succinct narrative reporting should be strongly encouraged.

12.1 IMA supports this Recommendation. Investors are increasingly concerned about the length, clarity and focus of annual reports in that reporting has become increasingly complex. In particular, the narrative information in the "front half" of an Annual Report and Accounts could be presented more clearly and the accounts as whole could be more cohesive. For too many organisations, reporting is seen as a legal compliance process, rather than as a process for communicating what matters. This shopping list approach makes it more difficult for companies to deliver real strategic thinking and close the gap between the transparency provided by those companies that genuinely think long-term and those that do not.

12.2 Investors want material strategic issues disclosed not the issues per se. We support Government's proposals in this area⁷⁵ and the FRC's current discussion paper "Thinking about financial reporting disclosures in a broader context".⁷⁶ However, in general IMA believes the detail of narrative reports is best developed by market practitioners, the preparers and users of the information. This is a role that could be fulfilled by the FRC's Financial Reporting Lab which aims to provide an environment where investors and companies can come together to develop pragmatic solutions to today's reporting needs.

Recommendation 13. The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations

Recommendation 14. Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment

13.1 As regards, Recommendations 13 and 14, the asset management industry is varied and models and metrics develop. We consider regulators, including for IMA members the Financial Conduct Authority, are well placed to conduct thematic reviews of such matters and are bound to have noted and be considering these Recommendations. In this context, some of our members are concerned about the tendency of regulators to prescribe "one size fits all" and require substantive evidence. Nor do we believe Government would necessarily be the appropriate body for such specialised and interactive work.

Recommendation 15. Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business

15.1 Incentive structures for executive directors in the listed sector are an important driver of behaviours and in principle, IMA supports this Recommendation. Investors want companies to have remuneration policies that are aligned with their interests such that they promote long-term value creation, take account of the fact that effecting change to a company's strategy takes time, and mirror a company's development cycle.

15.2 Too frequently remuneration structures are based on short-term earnings and share price. Even long-term incentive plans (LTIPs) rarely extend beyond three years. Also, benchmarking executive remuneration to the size of the business creates a motive to acquire businesses to boost directors' earnings. There are a number of examples of acquisitions which in the long-run destroyed value. The short tenure of certain executives can compound this in that it is often not long enough to see the rewards from an investment. Certain authors have argued that a focus on earnings has given wrong incentives to management and that alternative metrics should be considered⁷⁷.

15.3 We welcome the improvements that Government is making in improving transparency so that a company's future pay policy is clear and easily understood, and that there is a clearer link between pay and a

⁷⁵ Page 6 of the Government's response.

⁷⁶ <http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/October/FRC-publishes-paper-to-enhance-disclosure-in-finan.aspx>

⁷⁷ https://secure.cfauk.org/assets/2162/CFAUKDBIS_Long_Term_responseSENT.pdf

company's strategic objectives and performance. The policy report is to look forward and be subject to a triennial binding vote unless the policy changes. The implementation report looks back on how the policy was effected in practice and is to be subject to an annual advisory vote.

15.4 Undoubtedly the time horizons over which management is incentivised need to be addressed. However, our preference would be for the Recommendation to set out the principles that should underlie any long-term incentive plans rather than prescribe they should be by way of shares—shares are an effective way to incentivise long term performance, but are not the only way. Moreover, requiring executives to hold the shares until after they have retired could result in them leaving a company when they consider it the best time to realise those shares. Certain of our members consider that a suitable compromise between career shares and the current standard practise for three year LTIPs would be five year LTIPs. There need not necessarily be a five year vesting period but at a minimum, there should be a period of at least five years between the date of grant of the award and any sale of shares. However, in general we believe, the Government's changes should be given time to take effect before further measures are considered.

Recommendation 16. Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund

16.1 If asset managers are listed they are subject to the same requirements as the listed sector. In any event they are regulated entities supervised by FSA. The FSA has set out clear principles in its Remuneration Code, which derives from European legislation. It applies to investment managers regulated under MiFID and is to be extended to fund managers under UCITS and AIFMD. European law requires firms to apply "remuneration policies, practices and procedures that are consistent with and promote effective risk management". Thus remuneration has to be aligned with the risks of the firm and Code Staff pay has to be disclosed. We do not believe there is a case for further regulation.

16.2 Specifically an individual portfolio manager's performance may commonly be assessed on a medium to long-term basis, with other factors such as client satisfaction, attitude to risk, and the extent to which the employee is a team player taken into account. For example, for an individual fund managers' remuneration, the basic/fixed part is around 30 to 40% of the total and the performance part is around 60 to 70%, of which a significant amount is deferred over two to four years. As well as bonuses being deferred they are also subject to claw back arrangements where targets are not met. To quote various asset managers:

- "[Our] remuneration policy is team based and 75–80% of bonuses is paid in shares and has a three year vesting period. There is therefore no incentive to focus on one year's performance."
- "[We] are increasingly charging performance fees, which are based on at least a year-on-year performance. Remuneration of individual fund managers is based on a mix of team, fund and individual performance (roughly a third each) and no changes have recently been made to this policy."
- "There is no linkage with fees and short termism if they are calculated on an ad valorem basis. [It] does have some funds with performance fees which are calculated each year. Where there has been some underperformance however the fund has to get back to its starting position before any subsequent outperformance can be rewarded. [It] believes this aligns them with the client and as they are building a long term relationship does not lead to taking risks in the short term."
- "[We] have no remuneration structures whether for managers or the company, which incentivize an increased turnover of securities."
- "[Our] individual asset managers have their remuneration linked to 1 and 3 year performance cycles."

16.3 While the level of fees has an impact on performance, individuals are paid by the firm, not by the client, so that decisions about an individual's remuneration do not affect the cost to clients. In any event, due to the way the industry is remunerated asset managers', companies' and clients' interests are aligned. The better the company does, the better clients and asset managers do. Whilst providing a performance incentive in the form of an interest in the fund to be held at least until the portfolio manager is no longer responsible for that fund may be conceptually attractive, it could encourage a portfolio manager to leave at a time when their particular fund is performing well for clients and in many asset managers, it is not an individual portfolio manager that is responsible for a particular fund.

Recommendation 17. The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.

17.1 Whilst we would welcome Government exploring the cost of intermediation to investors so that they can hold shares directly on an electronic register, this matter is being looked at as part of the proposed EU Securities Law Directive.

STEWARDSHIP

IMA has been a long-standing supporter of the stewardship agenda. We firmly believe many clients of asset managers expect stewardship responsibilities to be taken seriously when delegated to the manager, and those managers should and do respond to this.

It is also clear that this stewardship role has been transformed in the last decade. In 2002, investors gave new impetus to stewardship and the Institutional Shareholders' Committee (ISC⁷⁸), whose members, including IMA, represent virtually all UK institutional investors, issued the Statement of Principles.⁷⁹ This was the first comprehensive statement of best practice governing the responsibilities of institutional investors in relation to the companies in which they invest on behalf of the ultimate owners.

IMA benchmarked the industry's adherence to the Statement of Principles through regular surveys. Starting in 2003, these clearly demonstrated that engagement was evolving and becoming more transparent. The last survey to 30 June 2008 showed that 32 asset managers that managed equities amounting to 32% of the UK market actively engaged, voted their UK shares, and increasingly published their votes⁸⁰.

Nevertheless, institutional investors recognised that in the run up to the financial crisis there were failings in their scrutiny and challenge to banks' strategy and excesses, and that they needed to address this. The ISC took steps to do so and reissued the Statement of Principles as a Code in November 2009, modifying it to seek to improve the dialogue between institutional investors and companies.

The Government at the time wrote to the FRC asking it to adopt the Code and, following a public consultation, the FRC issued it as the Stewardship Code in July 2010. In December 2010, the FSA made it a requirement that authorised asset managers disclose publicly their commitment to the Code or their alternative business model. This aimed to ensure that those that appoint asset managers are aware of how a manager exercises its stewardship responsibilities, if any. The Code also expects those that commit to it to report to their clients/beneficiaries on how they have exercised their responsibilities and to have a public policy on voting disclosure.

It is important that this transparency is supported by practice. Over the last three years, under the direction of the FRC, IMA has looked at institutional investors' activities that underlie their policy statements drawn up under the Code. Our first report looked at the position as at 30 September 2010,⁸¹ our second to 30 September 2011⁸² and we plan to issue our third to 30 September 2012 in the first part of this year.

The second report summarised 83 responses to a questionnaire sent to 173 signatories as at 30 September 2011. The 58 Managers that responded managed £774 billion of UK equities, representing 40% of the UK market, and the 20 Asset Owners owned £62 billion (five Service Providers also responded but do not manage or own equities for investment purposes).

The report clearly demonstrated progress. For example:

- as at 30 September 2011 173 institutional investors had committed to the Code up from 80 as at 30 September 2010;
- all of the 2011 respondents now have complete policy statements on how they exercise their stewardship responsibilities whereas in 2010, six respondents only had a statement of their intention to produce one;
- in 2011, more of the 2010 respondents have client mandates that refer to stewardship;
- the 2010 respondents increased their resources responsible for stewardship by 4% in 2011;
- the proportion of votes cast increased in all markets in 2011; and
- a greater proportion of respondents publicly disclose their voting records—73.4% in 2011 as compared to 69.0% in 2010.

In conclusion, more UK institutional investors are committing to stewardship and are increasingly transparent about doing so.

In this context, asset managers are fiduciaries acting on behalf of their clients, they offer their clients a choice and take a range of approaches to managing money. Some believe that actively engaging with investee companies will achieve better returns. Others believe the best way to send a signal to a badly managed company and maximise returns for their clients is to sell their holding. Asset managers have a duty to act in the best interests of their clients at all times. If that interest is better served by decisions to buy and sell shares rather than seeking to persuade companies to change course, then it is not surprising that they should do so. A healthy

⁷⁸ The members of the ISC were: the Association of British Insurers; the Association of Investment Companies; the National Association of Pension Funds; and the Investment Management Association. In 2010 this was reconstituted as the Institutional Investor Committee made up of the Association of British Insurers; the National Association of Pension Funds; and the Investment Management Association

⁷⁹ <http://www.investmentfunds.org.uk/press-centre/2002/20021021/>

⁸⁰ <http://www.investmentfunds.org.uk/press-centre/2009/20090520-01/>

⁸¹ <http://www.investmentfunds.org.uk/research/stewardship-survey>

⁸² <http://www.investmentfunds.org.uk/assets/files/surveys/20120612-stewardshipcode.pdf>

market needs a variety of business models and approaches, and we would not support any prescriptive approach to the matter.

There are also limitations in what such oversight can achieve. Asset managers are restricted in terms of the information that is made available to them. They do not have insider status and are not privy to the same information as the executive or indeed the non-executive directors. It is not unreasonable for fund managers to take in good faith assurances and information from management. UK asset managers also typically have relatively small holdings, particularly in larger companies. However, given the lower propensity for non-UK shareholders to vote at general meetings, a manageable group of UK shareholders could together constitute a significant proportion of those voting on any poll. But, there are concerns that acting collectively with like-minded investors to bring pressure to bear on management could trigger issues of insider trading, changes of control and “the concert party” rules.

In conclusion, there are limitations in what engagement can achieve—asset managers do not run companies; they do not set strategy nor are they insiders, in that they only have access to information that is available to the market as a whole. Managers compensate for such information asymmetries by diversifying their portfolio construction. Nevertheless the main asset managers are committed to good governance and engagement as evidenced by the growing number of signatories to the Code. They recognise that not only does it help ensure that their investee companies are better run but should also help ensure a sustainable and stable financial system.

ANNEX 2

A MECHANISM FOR COLLECTIVE ENGAGEMENT

One of the recommendations in the report was that: “an investors’ forum should be established to facilitate collective engagement by investors in UK companies”. The report states that this is to facilitate supportive and critical action on issues of concern to investors, in general and in relation to particular companies.

The day the Government’s published its response to the Review⁸³ we announced our intention to seek to facilitate the establishment of a mechanism that would respond to the objectives of the Review in this regard.

We are currently engaging with the investment community and completing a series of one-to-one meetings (including overseas, SWF and hedge fund investors) and some group discussions.

At the conclusion of this process, we will seek to determine, with other potential partners, whether it is possible to construct a mechanism that would secure sufficient support to add value to the collective forums that already exist.

ANNEX 3

IMA POSITION PAPER ON FIDUCIARY DUTY

EXECUTIVE SUMMARY

- Discretionary investment management is an agency relationship governed by contract. Fiduciary duties for investment managers arise from their role as agents.
- The contract sets out the detailed rights and responsibilities of the parties. Under the contract, the investment manager owes its client a duty to perform the contract with due care and skill (this is distinct from any fiduciary duty). The contract may modify and circumscribe fiduciary duties which may otherwise apply to the agent/principal relationship.
- UK and EU regulators impose an additional level of protection by substantially codifying many areas that fiduciary duties are intended to address.
- So while contract may modify fiduciary principles, there is a regulatory overlay such that fiduciary standards set in regulation are not capable of being contractually overridden.
- Thus, the principal aspects of fiduciary duties for investment managers are governed by a combination of fiduciary principles at law, contract and regulation.

SCOPE OF PAPER

The paper describes the relationship between a discretionary investment manager and its institutional client, focusing exclusively on segregated mandates. We will be undertaking further work to analyse the position in relation to pooled vehicles.

It describes the agency nature of this relationship from which fiduciary duties arise, the contractual arrangements between the parties and what they are intended to achieve and the regulatory context to which investment managers are subject. The paper explores the relationship and hierarchy between these three aspects: fiduciary principles, contractual obligations and regulation.

A general overview of the asset management business and the various players in the investment chain are set out in the Appendix to this paper.

⁸³ <http://www.bis.gov.uk/assets/biscore/business-law/docs/e/12-1188-equity-markets-support-growth-response-to-kay-review>

The paper sets out the position as a matter of English law and under relevant UK and EU regulation. It does not consider in any detail the legal obligations of an investment manager's direct clients to their own clients, for example where the manager's client is the trustee of a pension scheme.

I. KEY RELATIONSHIPS

Discretionary investment management relationship

A discretionary investment management relationship is a relationship pursuant to which a client engages an investment manager to provide the service of investing that client's assets on its behalf in accordance with certain investment guidelines that have been agreed between the client and the investment manager. Typically, the client gives to the investment manager full discretion to act for and on its behalf to invest a portion of its assets without needing to obtain the client's agreement to any specific transaction.

An example of a discretionary relationship would be Pension Fund X wishing to appoint an investment manager to manage a £100 million of its assets in global equities. As the result of a selection process that we outline in the Appendix, Investment Manager A would be given authority to invest this in line with the agreed terms (the "mandate").

(A discretionary investment management relationship is distinct from an advisory relationship where only advice is provided and the client makes the final investment decision.)

Agency relationship

A discretionary investment management relationship is by its nature an agency relationship with the client as principal and the investment manager as agent having typically been given authority by the client to invest the client's assets.

Contractual relationship

A discretionary investment management relationship is now invariably governed by a contract between the client and the investment manager. Thus the agency relationship between the investment manager and its client arises by express written contractual agreement. This contract is usually known as an "investment management agreement" and it contains, *inter alia*, an express appointment by the principal and an agreement by the agent to accept the position. As a matter of contract and agency law, the investment manager (as the client's agent) is under a duty to act within the scope of the authority given to it by its client.

Investment management agreements are comprehensive and lengthy documents which, in addition to the agency appointment, cover all matters arising in the relationship from commencement to termination and all matters in between. The investment management agreement will set out the rights, duties and responsibilities of the parties as well as the commercial substance of the contract namely the investment objectives of the mandate, how they will be achieved, any special requirements or restrictions and any appropriate benchmarks and performance standards.

The Investment Management Association has produced a model discretionary investment management agreement which is widely used in the industry. The current model agreement is 45 pages long. It is only a model agreement and is invariably tailored to the specific requirements of the parties. Some investment managers and some clients produce their own version of discretionary investment management agreements. These agreements are usually equally comprehensive and lengthy.

As a general observation, investment management agreements are frequently heavily negotiated between the parties. Clients are often professionally represented in these contract negotiations (whether by their lawyers or, where relevant, by their investment consultant (see Appendix for further details)).

II. THE CONTRACTUAL POSITION

The investment manager has a contractual obligation to provide the services as set out in the investment management agreement. These contractual duties are distinct from fiduciary duties.

The investment manager has a contractual obligation (whether express or implied) to perform its obligations with reasonable care and skill in accordance with the standard of care that could reasonably be expected of a professional discretionary investment manager. The duty of care and skill is distinct from a fiduciary duty.

The duty of care and skill does not exist in a vacuum. It is determined principally by the terms of the service the investment manager has been asked to provide. If a pension scheme client wanted to alter the scope of the mandate it gives to the investment manager, clearly it could do this, but the investment manager's contractual obligation is to follow the mandate given to it by the client. For the investment manager to follow a separate social or other policy that is not in the mandate could be a breach of duty and, if it were a breach, the investment manager would be acting outside the scope of its authority as agent.

If the manager or someone else benefited from such action, conceivably it might also amount to a conflict of interest where the investment manager was favouring someone else's interests at the expense of its client.

It would always be open to Parliament to create new duties by statute, for instance requiring an investment manager when acting for a pension scheme to take account of various matters outside the scope of its contractual mandate. But that would be the creation of a new statutory duty.

Another important aspect of the contractual relationship is that the investment manager has a direct contractual relationship with its client but it does not have a contractual relationship with its client's own underlying clients who are the investors or beneficiaries and may not have any information about them.

So taking the example of a UK trust based pension fund, the investment manager's client is the scheme trustee. The investment manager owes its contractual duties to the trustee and not to the scheme's beneficiaries. The pension scheme trustees have distinct duties and responsibilities towards the scheme beneficiaries.

III. FIDUCIARY PRINCIPLES IN EQUITY

Fiduciary principles were developed in Equity (as opposed to common law) and as a result the evolution of the principles owed much to the situation-specificity and flexibility which are Equity's hallmark. The nature and the scope of fiduciary duties have been developed by the courts over time in cases which examine disparate fiduciary relationships. Further, this is not a static area of law; it will keep evolving. By its very nature and purpose, the concept needs to retain some elasticity.⁸⁴ It is recognised as a complex area of law.

As a matter of English law, certain relationships are considered "fiduciary" relationships giving rise to fiduciary duties. There is no exhaustive list of the categories of fiduciary relationships. The archetypical fiduciary relationship is the trustee-beneficiary relationship but other recognised fiduciary relationships include company directors/companies, solicitor/client and principal/agent. The distinctive feature of agency is that the agent has power acting on behalf of its principal to change its principal's relationship with third parties.

In view of the inherent flexibility of the fiduciary duty doctrine in Equity, there is currently no single all-embracing general definition of what a fiduciary duty involves. Nevertheless, particularly in the context of an agent-based relationship, the nature of the fiduciary obligations are reasonably clear even though they may have been summarised in different ways and have been expressed differently at different times by the courts. For our purposes, in relation to an investment manager, to say that a firm is a fiduciary means that it has a special relationship of trust (though it is not a trustee) and confidence with its client and a corresponding duty of loyalty. The duties ascribed have been variously described as a "duty of loyalty", a "duty to avoid conflicts", a "duty not to make secret profit", a "duty to act in the best interest of the client", a "duty of good faith", a "duty of confidentiality", etc. The Law Commission's approach⁸⁵ in relation to fiduciaries generally (not just agents) was to summarise the fiduciary duty in four basic rules from which the various forms of fiduciary duty could be developed. The four basic rules are:

1. the "no conflict" rule;
2. the "no profit rule";
3. the undivided loyalty rule; and,
4. the duty of confidentiality.

IV. THE ROLE OF CONTRACT AND ITS RELATIONSHIP WITH FIDUCIARY DUTIES

It is crucial to understand that many of the fiduciary principles developed in case law stem from days where there were no detailed contracts. Equity was there to provide certain standards in cases where the contract did not do so or there was no contract. As Equity was effectively stepping in to do something for someone, the standards developed in case law were extremely high and the principles developed were broad brush in nature. Fiduciary duties as set out in the case law are therefore at the strictest end of the scale.

The purpose of a contract between parties is to define the rights and duties arising between them. So for example, in the case of an agency relationship, where this is agreed, the result may be to modify and circumscribe the fiduciary duties which would otherwise apply to a principal/agent relationship.

The scope of fiduciary duties and the impact of express and implied terms on those duties are examined in the leading case in this area *Kelly v Cooper* (1993). This case is of particular importance. It confirmed that where a fiduciary relationship arises out of contract, a clearly worded duty defining or exclusion clause will circumscribe the extent of the fiduciary duties owed to the other party. The Law Commission commented as follows on *Kelly v Cooper*.

"We examined Kelly in detail in paragraphs 3.24–3.36 above, and concluded that it is now clear that the scope of the fiduciary duties owed by an agent to his principal is defined by the express and implied terms of the contract of agency, and that a clear and unambiguous duty defining or exclusion clause will delimit the scope of the fiduciary duties owed to the customer. However, in determining whether a relationship is

⁸⁴ "Equitable principles have above all a distinctive ethical quality. They are of their nature of great width and elasticity ...

[T]he establishment of fiduciary duties ... may arise in any circumstances at all, whether or not similar circumstances have come about previously..." Spry, *Equitable Remedies* (3rd Ed 1984)

⁸⁵ Law Commission of England and Wales *Fiduciary Duties and Regulatory Rules* (no 236 1995 December 1995), paragraph 1.4

*fiduciary, and if so the extent of the fiduciary duties, its description in the contract will not be conclusive if it does not reflect the true substance of the relationship*⁸⁶

If the fiduciary duties were not modified or circumscribed using contractual techniques, the strict principles arising in equity might apply. This may not represent the intention of the parties as to how they wish their relationship to operate and in certain cases a party would not, in practice, be able to comply with the principles which would otherwise apply. It is therefore usual for a contract to define the duty an agent owes to its principal in some detail, with the result that the scope of the fiduciary duties owed are defined by the contract.

V. FIDUCIARY DUTIES AND CONFLICTS OF INTEREST IN THE INVESTMENT MANAGEMENT CONTEXT

In the financial services arena, a firm acting “for and on behalf of its client” is likely to be acting in a fiduciary capacity. Specifically, the agent-based fiduciary is typified by the discretionary investment manager exercising discretion over the client’s assets it manages.

In the context of the relationship between a discretionary investment manager and its client, various potential conflicts of duties and interest may arise. For example, firm/client conflicts may arise in the area of fees and other benefits often involving third parties—covered in regulation by the concept of “inducements” eg a firm pays a commission or fee to a third party which is deducted from the investment the client makes through the firm, or a commission is earned by the firm in connection with its mandate from persons other than the client. Client/client conflicts may, for example, manifest themselves in areas such as aggregation and allocation of a block trade across different client accounts and arranging transactions between clients (agency cross trades).

Investment managers deal with these potential conflicts by setting out the duties and responsibilities of the parties (ie the investment manager’s direct client and the investment manager) in a detailed investment management agreement. The agreement will define the scope of the fiduciary duties owed and what the investment manager can and cannot do. However, the position on conflicts including conflicts management in the financial services area has been substantially codified by regulation. An investment manager, as a regulated investment firm (see Appendix for further details), is required to adhere to that regulation and the contract cannot override any regulatory requirements.

VI. THE FINANCIAL SERVICES REGULATION

Financial services regulation introduces protections in many of the areas that fiduciary duties are intended to address through various conduct of business rules and in particular the conflicts of interest rules. The starting point is the concept of a conflict, not the concept of a fiduciary, although the existence of a conflict presupposes the existence of a fiduciary relationship (in the UK in any event).

The relevant EU legislation for asset managers is the Markets in Financial Instruments Directive (MiFID) and its implementing legislation. MiFID Level 1 Article 19 sets out the general principle for an investment firm to “act honestly, fairly and professionally in accordance with the best interests of its clients...” There are further detailed provisions at Level 2 (Art 26 ff). In the UK, FSA Principle 6 on “Customer’s interests” provides that:

“A firm must pay due regard to the interests of its customers and treat them fairly” and this is also reflected in chapter 2 of the FSA’s Conduct of Business Sourcebook.

The main EU rules on conflicts are contained in MiFID L1: Art 13(3) and 18; Level 2 Art 21–23. In the UK, FSA Principle 8 on “Conflicts of interest” provides that “A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client”. The MiFID conflicts rules are implemented in the UK in SYSC 10 of the FSA Handbook.

The MiFID conflict rules which apply to all discretionary investment managers now require that conflicts are managed as far as practicable and that only those which cannot be managed are then put to the client so that consent to their existence can be sought.

In some cases, regulation deals with certain conflicts by prescribing a particular way of dealing with them. Examples include the best execution rule, rules on aggregation and allocation of trades, rules on inducements and rules on commission sharing.

The regulatory treatment of conflicts is detailed and comprehensive. This section only provides a high level overview.

VII. THE RELATIONSHIP BETWEEN FIDUCIARY PRINCIPLES, CONTRACT AND REGULATION

The contract will define what the rights and obligations are between the parties—and so may affect the fiduciary duties. It would be possible for a fiduciary duty to co-exist with a contract depending on what the contract said. However, if the parties had agreed to something eg how to deal with conflicts, that agreement could change the fiduciary duty that would otherwise apply.

A regulatory requirement takes precedence over a contractual provision in the sense that a regulated person must follow it and can be sanctioned and fined by the FSA if it does not (regardless of what the contract says).

⁸⁶ Law Commission of England and Wales Fiduciary Duties and Regulatory Rule s (no 236 December 1995), paragraph 7.3

Regulatory rules relating to the areas of fiduciary duty may co-exist with fiduciary principles at common law and in equity. The regulators may have refined, restated or modified requirements of a fiduciary duty in a given context in the light of the totality of the safeguards under the regulatory scheme. Regulatory rules may potentially conflict with common law and equitable rules thus giving rise to uncertainty. The Law Commission considered this issue and concluded as follows:

*“We said in the consultation paper that we believed that a court, faced with a mismatch between fiduciary duties and what is required or permitted by regulatory rules, would probably take account of regulatory rules in determining the content of the fiduciary duty. Although there have been no cases since then directly on this point, we believe that the approach of the courts in cases such as Kelly and Target Holdings would tend to support this conclusion. We also accept that contractual techniques can go a long way towards dealing with most problems of mismatch which are likely to occur. We do not consider that, in general, the remaining difficulties and uncertainties are such that we should pursue the provisional recommendation 9 that there should be legislation to the effect that fiduciary duties should take account of regulatory rules in the light of the limited support it received on consultation”.*⁸⁷

We are of the view that while it would be open to the courts to apply a separate common law approach to financial services firms’ conflicts, the regulators’ conflicts rules are likely to be a significant factor in any court decision (provided there was authority to make the rule and subject to a reasonable regulation test). The likelihood is that the two regimes will gradually harmonise with the regulatory regime increasingly being treated as setting the market standard of behaviour and taking the lead in future developments.

VIII. CONCLUSION

The agency model that defines discretionary investment management services gives rise to fiduciary duties for investment managers.

While fiduciary principles at law may not be capable of exact definition and need to retain that inherent quality of flexibility which characterises the law in this area, the principles have been articulated in a reasonably clear manner as regards the principal/agent relationship which is how fiduciary duties arise in a discretionary investment management relationship.

The contract spells out in detail the rights, duties and obligations of the parties. Independently of any fiduciary duties arising, investment managers have a separate and distinct duty of care and skill towards their clients. The contract may modify and circumscribe fiduciary duties which would otherwise apply in the principal/agent relationship. The primacy of contract has been affirmed in a landmark case in this area.

However, in the financial services context, many areas that fiduciary duties are intended to address have been codified in regulation at UK and European level. There is, as a result, a regulatory overlay which contract cannot override.

Therefore, fiduciary duties as they arise in a discretionary investment management relationship are governed by a combination of fiduciary principles at law, contract and regulation.

November 2012

PIRC Analysis of Voting on Director Elections 2009 to 2012

SECTION 1: VOTING TREND ANALYSIS

Table 1

AVERAGE LEVEL OF OPPOSITION BY YEAR FOR ALL RESOLUTIONS

Year	Average Oppose%	Average Oppose & Abstain %	
2009	1.41	1.99	
2010	2.00	2.76	
2011	1.92	2.80	
2012	2.30	3.26	

⁸⁷ Law Commission of England and Wales Fiduciary Duties and Regulatory Rules (no 236 December 1995), paragraph 14.20

Table 2

STANDARD DEVIATION OF LEVEL OF OPPOSITION BY YEAR FOR ALL RESOLUTIONS

<i>Year</i>	<i>Average Oppose%</i>	<i>Average Oppose & Abstain %</i>	
2009		4.75	5.82
2010		5.12	6.32
2011		4.49	5.71
2012		5.26	6.92

Table 1 shows that, with the exception of 2011, there has been an increase in the average oppose vote year-on-year. When the definition of shareholder concern is expanded to include abstention there is a year-on-year increase in average shareholder dissatisfaction.

Table 2, shows that over time the standard deviation of opposition and dissatisfaction has increased, indicating more outliers with high levels of opposition. This together with the unconformity of the value year-on-year, indicates that shareholders are not necessarily working together to focus concerns on one particular resolution.

Table 3

FTSE100 DIRECTOR ELECTION ANALYSIS (PROPOSED BY THE COMPANY)

	<i>2009</i>	<i>2010</i>	<i>2011</i>	<i>2012</i>
No. of proposals	491	541	991	1029
No. withdrawn prior to meeting	1	3	5	1
No. put to meeting	490	538	986	1028
No. of directors not elected	0	0	2	0
Average % For	97.73	97.91	97.5	97.4
Average % Oppose	1.57	1.54	1.6	1.5
Average % Abstain	0.66	0.53	0.87	0.60
No. of proposals > 10% Oppose	14	3	17	23

Table 4

FTSE350 DIRECTOR ELECTION ANALYSIS (PROPOSED BY THE COMPANY)

	<i>2009</i>	<i>2010</i>	<i>2011</i>	<i>2012</i>
No. of proposals	1246	1419	2575	2972
No. withdrawn	8	10	10	8
No. put to meeting	1238	1409	2575	2964
No. of directors not elected	0	2	2	0
Average % For	97.15	97.47	97.46	96.48
Average % Oppose	1.81	1.76	1.67	1.88
Average % Abstain	0.86	0.71	0.75	1.02
No. of proposals > 10% Oppose	40	31	56	97

DIRECTORS NOT ELECTED

EURASIAN NATURAL RESOURCES 2011: Sir Richard Sykes and Kenneth Olisa were both voted off the board. The company has a number of significant shareholders who may or may not have voted en-bloc. There are no obvious governance concerns that would lead shareholders to oppose these directors on audit issues. PIRC has contacted the company for further information on this point. To date the company has not responded.

MITCHELLS & BUTLER 2010: 4 directors (Mitchells & Butlers Plc) were to be appointed by shareholders at the 2010 AGM. Piedmont Inc, who is a 22.8% shareholder, put forward these four resolutions. We have concerns over the independence of the nomination process to appoint them, and consider that they might not act in the interests of all shareholders. At the same time two director were not re-appointed.

PROPOSALS WITHDRAWN IN 2012

SVG CAPITAL: Following an immediate press release on 12 March 2012 before the AGM, Denis Raeburn (NED) decided to retire from the board at the forthcoming AGM on 23 March 2012. As a result, Denis Raeburn would not stand for re-election as a director at the AGM.

DECHRA PHARMACEUTICALS PLC: 1 director from Dechra Pharmaceutical Plc withdrew before the AGM. There was no relevance concerning the resolution on the re-election of Simon Evans (Finance Director) since he resigned from the board. The company stated following the acquisitions of other two companies

(Eurovet and Vetxx); it was time to recruit a finance director. There were no other issues in regards to his re-election.

REDROW PLC: 1 director from Redrow Plc withdrew before the meeting. Paul Hampden Smith notified his resignation to the board before the meeting. There were no issues in regards to his re-election. It is worth noting that the executive chairman of the board held around 40% of the company.

AVIVA PLC: 1 director from Aviva Plc withdrew from the AGM. The resolution concerning the re-election of Igal Mayer was no longer relevant as he resigned from the board on 19 April 2012. There were issues about the excessiveness of the company's remuneration structure.

RIT CAPITAL PARTNERS PLC: Three directors from RIT Capital Partners Plc withdrew from the AGM in July 2012. Mr Mikael Breuer-Weil (Executive director) withdrew before the meeting, announcing that he would start his own money management business. Furthermore, as a result of the company's recent strategic investments, Messrs Rick Sopher and Bill Winters withdrew before the meeting and would be joining the board of J Rothschild Capital Management Ltd (JRCM). JRCM is a subsidiary of RIT Capital Partners Plc.

HALFORDS GROUP PLC: One director from Halfords Group Plc withdrew before the AGM in July 2012. Mr David Wild (CEO) left the board as CEO with immediate effect. His sudden resignation came in effect after a profit warning over a consistent period of underperformance.

Information is believed to be correct but cannot be guaranteed. Opinions and recommendations constitute our judgement as of this date and are subject to change without notice. The document is not intended as an offer, solicitation or advice to buy or sell securities. Clients of Pensions & Investment Research Consultants Ltd may have a position or engage in transaction in any of the Securities mentioned.

**Short statement provided (in personal capacity) by Harlan Zimmerman of Cevian Capital
(Providing oral evidence 26 February, 2013)**

NON-EXECUTIVE DIRECTORS AND FAILURES IN THE PRINCIPAL-AGENT RELATIONSHIP⁸⁸

Over the last years equity markets have done a poor job of providing capital for British business. They have also done a poor job of acting as a control mechanism to steer British listed companies towards the sort of behaviour that society requires and, increasingly, demands.

The Kay Review comprehensively discusses the problems associated with principal-agent relationships throughout the investment chain, but has virtually ignored the all-important relationship between the shareholders (the principals) and non-executive directors (or NEDs, who are agents). While NEDs have obligations to their companies as a whole, shareholders alone vote on NED appointments so that they may select NEDs who they can entrust with the stewardship of the companies that they own.

However, this is not how things have been working in practice, and this is the root of many problems.

Shareholders have largely abdicated their right to appoint NEDs, as voting for NEDs has become a largely farcical rubber-stamping exercise that (to borrow from Lord Myners) would embarrass even the North Koreans. As evidence, note data from PIRC on FTSE 100 director elections for 2009–2012: There were 3,042 votes on director nominees during this period. In 3,040 cases (99.34%), the nominees were voted onto the board. (two nominees were voted down by controlling Kazakh owners). Average “yes” votes were c. 97.5%. Even in 2012 (the so-called “shareholder spring”), 100% of FTSE 100 nominees were voted through, with an average “yes” vote of 97.4%.⁸⁹

(This behavior is especially disappointing as appointing directors is the shareholders' single most powerful tool of ownership, and by failing to exercise it, they are failing to fulfill their “*primary role in promoting the accountability of management and boards for the performance of their businesses.*”⁹⁰)

It is the boards themselves (normally really the chairmen) that control the NED nomination process. Thus, with 99.34% success rates, the boards (chairmen) effectively control the entire appointment process. In other words, the chairmen are selecting their own board members. This is a very bad outcome that is the root cause of much sub-optimal behaviour.

Human nature means most chairmen will avoid selecting “natural challengers,” and most NEDs—having been given their job by the chairmen—will not be comfortable rocking the boat. (They also understand that appointments to other boards will be difficult without a good reference from their chairman).

When chairmen select NEDs who are not natural challengers, and when NEDs are uncomfortable rocking the boat, the result is a lack of challenge in the boardroom. This leads to poor decision-making, limited accountability and improper alignment of interests. (The Walker Review of BOFIs pointed to lack of boardroom challenge as a major cause of the sort of behaviour that led to the financial crisis).

⁸⁸ Many of the points in this document are discussed in greater detail in Cevian's submission to the Kay Review.

⁸⁹ During these four years there were also a total of 10 director proposals that were withdrawn prior to the vote. Comparable figures for FTSE 250 companies were 5,134 director votes, all but two were appointed. 26 withdrawn.

⁹⁰ Text in italics taken from the background information and call for evidence of the Kay Review.

Furthermore, NEDs virtually never even meet shareholders (other than the chairmen and occasionally senior independent directors). They rely on CEOs and CFOs (who do meet shareholders) and corporate banking advisors to inform the board about shareholder views. As the interests of management and bankers often diverge from the interests of shareholders and society at large, this is clearly sub-optimal.

Lastly, in an election system with candidates chosen by a single party and 99.34% of candidates winning their races, it is doubtful that the winners would feel empowered by a true mandate from the voters. It is likewise difficult to believe that NEDs feel any sort of true mandate or backing from shareholders.

CONSEQUENCES OF POOR BOARD BEHAVIOUR

Poorly functioning, out-of-touch, non-accountable boards display many symptoms that are damaging for stakeholders and society. These include:

- Inappropriate risk-taking, strategic errors, poor acquisitions and capital management—arising from insufficient control over ambitious management teams, who often have asymmetric incentives and a desire to expand their domains.
- Weak governance—chairmen, NEDs and executives who perform “well enough” to keep their seats, but are not compelled to drive a company to its potential; poorly managed succession processes.
- Executive remuneration—Plans with targets that are too low, purely financial, and poorly aligned with the interests of shareholders and wider stakeholders; inappropriate benchmarks and structures; and unreasonably high levels of compensation.
- Corporate underperformance—arising from un-ambitious, unchallenging and inappropriate target setting.
- Short-term focused decision making—resulting from a lack of a mandate from shareholders, and thus a constant fear of missing quarterly estimates and disappointing “the market.”
- Lack of diversity—A lack of diversity within the board, resulting from managed nomination processes that lack transparency and objectivity, and that favour the “old boys’ network.”

Shareholders, other stakeholders and policy makers have limited time and resources. Much effort is expended on trying to address individual issues such as the ones listed above. However, it would be more efficient, and more effective, if attention were focused primarily on comprehensively improving board behavior, which would address many symptoms at one time.

SHAREHOLDER INVOLVEMENT IN BOARD NOMINATIONS

We believe that the most tangible and realistic way to comprehensively address poor board performance is to directly involve shareholders in the company’s NED nomination process.

This system operates well in Sweden (as well as in Norway and at most large companies in Finland) and benefits all—shareholders, companies, directors and society at large. While it would be inappropriate to simply take the Swedish system and apply it to the UK, there are important lessons that can be drawn from the Swedish experience. (An idea would be to involve shareholders in nominating only chairmen).

Like there was initially in Sweden, there is much resistance to this approach in the UK. The status quo suits current chairmen and NEDs, who can say they are in fact very responsive to non-public dialogue with shareholders (while keeping their ability to self-determine and perpetuate). Most institutional asset managers, meanwhile, will say they are very active behind the scenes (when this is true in very limited cases), and thus the current (low-cost, low responsibility) works reasonably well.

The Kay Review briefly mentions, but does not consider seriously, the possibility of involving shareholders in NED nominations (and the issues it would address). This is a missed opportunity. It is possible that Professor Kay felt, as with some other ideas paid scant attention (eg differential voting and dividends), that resistance would be so great, there would be little point in advancing such approaches. That would be a disappointing stance from such a respected thinker, chosen from out of the box, presumably to suggest some out-of-the-box solutions to the difficult problems we face.

Harlan Zimmerman
 Senior Partner
 Cevian Capital (UK) LLP
 22 February 2013

**Written evidence submitted by Fidelity Worldwide
(Providing oral evidence 26 February, 2013)**

I would like to thank you for your invitation to appear before the BIS Committee as it considers the Kay Report. Professor Kay has written one of the most authoritative reports on asset management that I have read in over 25 years in the industry. It is thought provoking, and I believe can help the industry define its purpose and future role.

While the report raises numerous serious issues that will require thorough discussion, there are three topics I would like to highlight before the panel hearing which may help the Committee's deliberations.

Firstly the report proposes that remuneration within asset management should be based on long-term, equity ownership. Fidelity endorses this proposal and believes that there is a strong case for reform. Long-term incentive plans are seldom longer than three years, which we consider too short. We feel that equity should be held for a minimum of five years, or, as in our case, until the individual leaves or retires. Once asset management remuneration has been reformed, the industry will be better placed to encourage boards in other industries to adopt longer term remuneration schemes.

Secondly, the report highlights the stewardship responsibility of asset management, and the broad benefits that yield from boards answering to an engaged shareholder basis. We would agree with this conclusion and have a very active corporate governance team engaging with UK companies on a daily basis. However, we find that many in our industry still 'vote with their feet', selling shares they deem unattractive rather than seeking to improve corporate performance. This is the 'free rider' problem. We would also add that the regulatory framework does not naturally assist a close working relationship between board and shareholder in the public market.

The market abuse regime, with good reason, restricts the information asset managers can receive, limiting the influence shareholders can bring to bear on directors. Somehow we need to resolve the twin goals of engagement with uniform information.

Finally, Kay argues that the industry has become too short-term. This manifests itself in a culture of quarterly performance reviews, high asset turnover, falling levels of client retention, and a plethora of new products such as hedge funds which cater to these trends. We agree that the industry has become too short-term in its thinking, and the persistency of client assets is an industry-wide problem. Our experience is that client persistency is weakest through bank distribution channels, and highest when we have a direct relationship with the client. There is certainly a need to simplify the layers of intermediation in the industry, while retaining the benefits that open architecture offers clients in terms of choice, transparency and cost.

There is so much in the Kay Report that warrants discussion. I am sure that I will be unable to do it justice, either now or during the panel session. However, I hope this letter will help your Committee extract as much from the panel session as it can.

Dominic Rossi
Global Chief Investment Officer
22 February 2013

Supplementary evidence submitted by Fidelity Worldwide

I greatly appreciated the opportunity to submit evidence to the Business, Innovation and Skills Committee last week as part of your deliberations on the Kay Review of UK Equity Markets and Long-Term Decision Making. There were two points on which I wanted to come back and expand on.

The first relates to question 150 and whether the shares managed by Fidelity International are classified as UK-owned or foreign-owned. I feel that I should elaborate my response, as the problem is that there are a number of answers. The official ownership is usually decided either by where the assets are managed or by the underlying beneficial ownership; but our attitude to our responsibilities is the same regardless of the beneficial ownership.

In London we manage £61 billion, £39 billion of which is managed for foreign clients and £22 billion for UK clients. The assets we manage for foreign clients would be classified as foreign-owned. Looked at another way, in terms of our investment for clients in UK equities, which would be the pivot for our stewardship role in the UK market, as of 31 January 2013 we managed £8.5 billion in UK equities for UK retail and institutional investors. We also invest approximately a further £4 billion in UK equities through other vehicles such as Pan-European and Global funds. These investors are likely to be from around the world. Our responsibility towards our investments in UK assets and the UK economy is the same regardless of ownership.

The second point relates to question 174 and Fidelity International's voting record. I indicated to the Committee that we had voted against management at 20% of the General Meetings in 2012.

Having revisited the specific figures, I can inform you that globally we voted against management on at least one resolution at 18% of the meetings at which we voted and that 33% of these votes related to Board

appointments, 31% to remuneration, 14% were in respect of shareholder proposals, 13% related to capital structure and 9% other.

I hope this is helpful but please feel free to contact me if you have any further questions.

*Dominic Rossi
Global CIO, Equities
5 March 2013*

**Written evidence submitted by Dr Paul Woolley
(Providing oral evidence 26 February 2013)**

In his introduction to the Government's response to the Kay review, Dr Vince Cable talks of "the prevalence of incentives to focus on short-term market movements rather than long-term value creation as the basis for investment decisions". The standard theory of finance cannot explain mispricing, short-termism and other market failures. That is why solutions have been elusive. My team has been developing a framework that addresses these issues and offers an agenda for reform of investment practice.

INVESTMENT VERSUS TRADING

There are basically only two investment strategies: investing based on fundamental value and momentum trading, or trend following. Everything investors do is a variant of one or other strategy, or some combination of the two.

Fundamental investing requires investors to estimate the future cash flows from securities and asset classes. This calls for skill and patience: skill in making the estimates and judging the risks, and patience while waiting for these judgments to be vindicated.

Momentum trading involves investors buying and selling assets simply in accordance with the prevailing trend in prices. It involves a succession of independent bets on the direction of those prices. The investor makes no judgment about the fundamental value of the security.

Investors use momentum either to try to make a quick turn, or to reduce the risk of underperformance in the short run. The distinction between the two strategies lies at the heart of the problem of short-termism and it goes beyond the debate about length of holding period.

Our analysis shows that while momentum traders may gain in the short-term, they lose out to fundamental investors in the medium and long-term. The reasons for this include that they are inevitably late to the party—buying after prices have started to rise and selling after they have begun falling. Momentum locks in losses, whereas the longer-term investor rides the troughs and enjoys the recovery when prices revert to the mean. The trading costs involved in "churning" the portfolios also detract from returns due to the ultimate asset owner.

"Momentum" is not just counter-productive for the medium to long-term investor. It is also a key component of the herd behaviour that leads prices to over- and under-shoot the fundamental value of the underlying assets. This damages market efficiency, making prices prone to excessive volatility, bubbles and crashes.

Given these clear drawbacks, why are pension funds and other long-term investors nevertheless drawn into the momentum game, either explicitly by pursuing short-term performance, or unwittingly via benchmarks and risk measures calculated using market prices? The reasons include:

1. Benchmarking to market-value-based indices. This effectively means buying high and selling low, and accepting prices that are distorted by momentum surges. Index-tracking is thought of as a cheap option, but it ties the investor to benchmarks mispriced by momentum trading.
2. Imposing limits on the divergence of fund returns from the benchmark's returns (to limit "tracking error"). This requires the fund manager to use momentum to hug the benchmark index to reduce the commercial and professional risks of underperformance.
3. Hiring "quant" managers guarantees that momentum will be part of the package. Similarly, most hedge funds use momentum as a core strategy overtly or covertly. Their high fees make the client impatient for quick results.
4. Paying performance fees based on annual returns encourages a short horizon and, therefore, momentum investing.
5. Focusing on mark-to-market valuations, compounded by regulatory requirements, leads to unnecessary—and often self-defeating—efforts to minimise short-term losses and volatility.
6. Bowing to pressure to measure performance against existing comparator universes can encourage herding in asset classes, pushing funds into the latest fashion (commodities, hedge funds, gilts) often with pleasing short-term results but disastrous longer-term outcomes. So careful choice is needed to ensure the comparators are relevant to the asset owners' needs.
7. Over-using derivatives (futures, options, structured finance), which are by definition short-term because most instruments expire in less than 12 months. Any fund manager using derivative strategies will be

focusing on either short-term gains or short-term risk reduction. The Kay Review failed to refer to the derivatives markets, which have now grown to be many multiples larger than the market in the underlying instruments.

What can be done about it?

We have written a Manifesto (see *The Future of Finance*, LSE Report 2010) for giant funds, such as pension funds and sovereign wealth funds. The Manifesto is our version of a code of best practice for long-term investors. It goes further than Kay's proposed statements of best practice for asset managers and asset holders. As is made clear in the G30's recent publication, "Long-Term Finance and Economic Growth", this is an international issue. Its number one proposal is that regulators at all levels should "promote long-term horizons in the governance and portfolio management of public pension funds and sovereign wealth funds".

The main aim of the Manifesto is to show funds how to reduce momentum trading and increase the focus on fundamental investing. If implemented, this would raise the medium- and long-run returns of individual funds irrespective of what other funds do. If large numbers of funds followed suit, markets would become more efficient and less exploitative. The key points of the Manifesto are:

1. Concentrate on investing based on the future cash flows of the assets and their ability to meet the cash obligations dictated by the liabilities.
2. Base all risk metrics for the assets on underlying cash flows, not current market prices.
3. Choose a cash flow-based benchmark tailored to the currency base of the investor, such as real global GDP growth plus local inflation.
4. Avoid investment strategies based implicitly or explicitly on momentum ie bets on price trends, or where buying/selling is prompted by automatic reactions to price movements.
5. Cap annual turnover of the portfolio at an indicative 30%. Managers would have to explain and justify excess turnover and the capping would force managers to focus on long-run value.
6. Design contracts with agents to minimise moral hazard, eg avoiding performance fees other than over the long-term.

We strongly advocate establishing a code of best practice for long-term investors along these lines. This could be backed up with the withdrawal of existing tax concessions for institutions that breach key provisions, such as the 30% limit on portfolio turnover. The authority to withdraw tax exemption if funds are deemed to be trading rather than investing has lain dormant and little used in the UK tax statutes for the past 30 years.

Because of their pro-cyclicality we also discourage the imposition of annual snapshot mark-to-market valuations for long-term funds. The regulation of both pension funds and insurers has moved in the direction of extending the requirement for, and frequency of, mark-to-market valuations. This is a retrograde step that trumps attempts by funds to adopt a long-term strategy. This legislation comes in response to volatile and treacherous markets yet will have the effect of making matters worse, not better.

As funds begin to adopt the new practices, a new comparator universe of long-termist funds would be created. This would ease the concerns of those who fear short-term underperformance in the event of a new momentum-fuelled bubble. The other side of the coin is that members of pension schemes would be able to challenge trustees who fail to comply with the new code and suffer underperformance as a result.

Curbing short-termism would also be a big help in shrinking agency costs. Short-termism and volatility have contributed greatly to agents' ability to capture rents through moral hazard (heads the agents wins his fees, tails the client loses). More stable markets would make the finance sector less bloated and prone to crisis.

Action along the lines set out above would address several of the problems diagnosed by Kay for the asset owners' end of the chain. International opinion is also moving in this direction—see the G30 report published this month (as mentioned above).

In the UK, it is clear from the Government's response to Kay that it not only shares his diagnosis but is keen to see a fundamental change in investment practice. This includes essential regulatory reforms to favour investing over trading. The response also rightly indicates that a new financial framework is needed, since it can no longer be assumed that markets will achieve efficient outcomes. Hence the call for reviews of both metrics and risk management models.

We also welcome the Government's defence of the role of equity markets, in paragraphs 2.24 and 2.15 of its response to the Kay Review. Kay's dismissal of the value of equity markets as a source of funding may be a correct observation of the current facts, but equity markets are and should be the lifeblood of capitalism. They are failing because of the short-termism of all the players in the market, including corporations, and the rent capture by agents. The current policies of regulators are exacerbating the problem because, like the rest of us, they remain in thrall to the defunct theory of efficient markets, which assumes that market prices represent "fair value" in the sense of rational expectations of future cash flows.

POTENTIAL CONTRIBUTION TO FINDING SOLUTIONS

My colleagues and I have been planning for some time to establish a research forum to work with selected policy-makers, sovereign wealth funds, pension and charitable funds globally (similar to that suggested in Kay). The forum would help policy-makers draft the code of best practice for long-term investors and assist funds in implementing the code. It would also provide the new metrics for setting benchmarks and analysing risks. In addition, it proposes a code that would help companies to invest for the long term, in the context of reforms to the approach of investors.

The issue is a global one and we are addressing things at that level. Our approach is founded on the new framework we are developing for understanding finance (see attached article, “Capital market theory after the efficient market hypothesis”). The principal departure from the prevailing theory of efficient markets is to introduce the real-world feature that asset owners delegate management of their funds to agents such as asset managers, investment banks and brokers. Because the prevailing theory of finance is based on the efficiency of prices, it will never successfully explain price distortions, short-termism or other market failures. It certainly will not provide solutions. In contrast, our framework suggests the causes, consequences and remedies for market failure.

Since the Centre started at the LSE in 2007—before the financial crisis struck—our work has attracted widespread interest from academics, some policymakers and international agencies, journalists around the world and a select few practitioners. Most encouraging has been the reaction of sovereign wealth funds and large funds overseas, notably the Australian pension fund community. In the UK, while a change in approach would clearly be in the interest of pension scheme members, it is early days in the reform process. The outcome of these parliamentary hearings should provide impetus to that.

To get UK pension funds to show interest and even consider action will need a significant catalyst. It will take more than setting up a forum. The development and promulgation of a code of best practice would be a start, whether this comes from the IMF, Financial Stability Forum or some other national or supra-national body. The new code would act as a carrot to action, but it will also need a stick in the form of legislative back-up or the trustees’ fear of challenge by their members.

OTHER ISSUES

Company stewardship and engagement with management

We have focused on the asset owners’ end of the chain rather than on the investee listed companies. This is partly because our Manifesto is aimed at funds that will invest in a broad range of asset classes, not just domestic equities. We also believe that if the owners of the assets were focused on the cash flows from them, much of the responsible ownership behavior that Kay calls for would inevitably follow. Where engagement with the management would improve long-term performance, it would make sense to do it.

This would encourage managements to focus on long-term value creation. It would also discourage financial engineering and ill-thought-out takeovers—actions that might enhance short-term earnings but could be counter-productive longer term. It should also encourage management to be more relaxed about cyclical profit volatility or temporary suppression of earnings for investment purposes. This, in turn, might lead to less trading activity by company treasuries in the name of risk management, including in the derivatives markets.

INVESTMENT CHAIN AND COSTS

Three other elements of the Manifesto (see below) tackle the issue of too many intermediaries between savers and the assets they own, and the cost of those layers. They chime with other calls to make costs transparent and to hold intermediaries more closely to account. Combined with the discouragement of momentum trading, a welcome side effect would be to reduce the number of links in the investment chain.

1. Insist on total transparency by managers with respect to their strategies, costs, leverage and trading.
2. Work with other shareholders and policymakers to secure full transparency of banking and financial service costs borne by companies in which the large funds invest.
3. Provide full disclosure to all stakeholders and allow public scrutiny of each fund’s compliance with these policies.

I hope that this submission, coupled with evidence given on February 26, will help the committee to achieve Dr Cable’s goal of installing “long-term value creation as the basis for investment decisions”.

*Dr Paul Woolley, senior fellow, London School of Economics
The Paul Woolley Centre for the Study of Capital Market Dysfunctionality
25 February 2013*

Written evidence submitted by USS Investment Management Limited

Please find additional information following my recent appearance at the BIS Select Committee inquiry into the Kay Review of UK Equity Markets and Long Term Decision Making on 26 February 2013.

We provide below additional information in response to two questions posed by the Committee Chairman. We also highlight some key points that the Select Committee should consider in its deliberations. Finally, we provide information requested on USS's voting statistics requested during the discussions.

Q135/Q136 Chair: *Do you feel that organisations were sufficiently consulted by Professor Kay?*

We feel that the voice of pension funds—the asset holders for many of the assets in the UK—could have been better heard. Unfortunately, most pension funds lack the resources to contribute fully to such consultations and will almost invariably have their voices drowned out by better resourced intermediaries who may have a vested interest in the status quo. Those pension funds that are heard are usually the large ones including USS, BTPS, and RailPen, the funds that tend to be most actively involved in debates around long term investment and have the internal resource to do so.

We would also note that in our view, the brief given to Professor Kay was too focussed on one aspect of the investment universe—namely UK equities. Pension funds have a broader asset allocation, and in most cases the allocation to UK equities is decreasing. The inability to look beyond listed UK equities (eg to private equity, infrastructure and property for which stewardship and long-termism are also vital) has minimised the possible effectiveness of the review in terms of its benefits for UK investors and society.

Q138 Chair: *You also said to Professor Kay that “there are likely to be different solutions to the agreed problems.” Now, given the fact that we are trying to hold an inquiry to come to an agreed solution to agreed problems, what exactly did you mean by that? In effect, what would your solution be to what I think are generally agreed as the problems?*

It would not be sensible for government to try to dictate *one* approach or “silver bullet” to address the current problems with long term ownership/stewardship, and different funds will find their own way of achieving this. We highlighted in our joint submission with two of the other large UK pension funds (BTPS and RPMI), that we have each adopted different models, none of which involves outsourcing stewardship functions to external investment managers.

- USS has adopted a largely in-house investment management and stewardship function.
- Railpen's investment management function is entirely outsourced with stewardship led internally with a partial outsourcing to a specialist provider.
- BTPS' stewardship is undertaken by Hermes Equity Ownership Services (EOS) which sits within the asset manager BTPS owns and which otherwise manages only a portion of BTPS' assets.

For the smaller UK pension schemes who decide to delegate their responsibility for stewardship, we recommended efforts should be made to form collaborations between asset owners as this provides a mechanism to both reduce costs and increase the impact of such activities. USS, though itself a relatively large scheme, has benefitted by establishing a voting and engagement alliance with RPMI Railpen.

We also recognise there may be other solutions, and we would welcome our peers working to develop these. In addition, there are a number of formal collaborations where pension funds and asset managers work together on stewardship and other issues.

- The International Corporate Governance Network⁹¹ is collaboration between investors mainly focussing on improving global standards in corporate governance.
- The UN backed Principles for Responsible Investment⁹² operates an Engagement Clearing House, where signatories can get join together to engage with companies on specific issues—this is a kind of ‘a la carte’ investor panel.
- Eumedion⁹³ is a collaboration between Dutch investors which focuses on improving standards in companies in that market.
- The Australian Council of Superannuation Investors⁹⁴, is an exclusively pension fund group which engages on behalf of its pension fund members to improve governance and other long term issues.
- The Institutional Investors Group on Climate Change (IIGCC)⁹⁵ is a pan European collaboration focussing specifically on how the long term issue of climate change, and shorter terms policies to address it, could impact pension funds and other investors.

These are just some examples of where pension funds have come together to find solutions to specific issues related to their investments.

⁹¹ <https://www.icgn.org/>

⁹² <http://www.unpri.org/>

⁹³ <http://www.eumedion.nl/en>

⁹⁴ <http://www.acsi.org.au/>

⁹⁵ <http://www.iigcc.org/>

 KEY CONSIDERATIONS FOR ENCOURAGING LONGER TERM INVESTMENT

The following are a number of key points we believe the Select Committee should consider in its response to the Kay Review.

- *Leadership from the top:* we need to see board members taking the lead in terms of a long term focus at corporations, and trustees taking a lead at pension funds. This means the directors/trustees have to have the requisite skills to challenge management and the financial services chain.
- *IFRS and pension regulation:* The introduction of IFRS/mark to market accounting for pension funds has exposed funds to increased volatility and some difficulty in incorporating assessments that markets have overshot (in either direction) or that future income streams are not impaired to the implied degree. Such volatility and the potential introduction of Solvency II will be detrimental to investment in risk seeking assets such as public equities and other “risky” assets, including infrastructure—with adverse consequences for growth and for the affordability of adequate pension provision.
- *Investor Forum:* Pension funds and other asset holders are less likely to be conflicted, therefore should take a central role in any investor forum or vehicle established for collaborative engagements. The forum should also be adequately resourced, and needs to be free from the potential conflicts of interest which may exist within representative bodies for the wider industry.
- *Remuneration:* should be appropriately structured to encourage executives to manage business for the long term rather than for quarterly targets, and for investment managers to invest for the long term.
- *Pension fund scale:* UK pension funds are in general too small to adequately resource their stewardship operations. There is therefore too much reliance on intermediaries, which increases cost and thus decreases the return to pension members. Consolidation in the pension sector would increase professionalism and capacity to engage more fully in stewardship, as well as benefitting members (and taxpayers for public schemes).
- *Infrastructure:* The UK government and pension funds both wish to engage in other forms of long-term investment, including ‘illiquid’ investments such as infrastructure. USS is looking to invest increasingly in long-dated, inflation-linked income streams, in areas such as infrastructure, but there are some impediments to fulfilling this objective.

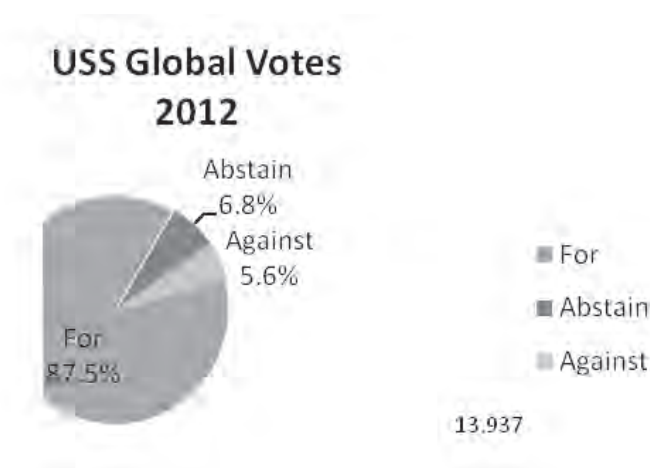
USS VOTING STATISTICS 2012

GLOBAL VOTING 2012

- The fund regularly votes >92% of its equities under management in the following markets: UK, USA, Japan, Australia, France, Netherlands, Germany, Switzerland, Spain, Belgium, Luxembourg, Brazil, Taiwan, Korea, and Russia. The fund may vote in other markets eg where we have a large holding, there is a material vote, or at the request from the portfolio manager.
- The fund has processes in place to recall shares from lending ahead of important voting events, and/or where we are a significant shareholder.
- All votes are reviewed and analysed by the in-house RI team.
- The fund usually writes to companies to explain the rationale behind votes against management, ahead of the meeting, where possible. The main issues highlighted include independent representation on the Board and its committees, auditor independence, misalignment of pay with performance, minority shareholder rights, dilution concerns, lack of transparency and disclosure.

2012 GLOBAL VOTING STATISTICS

13,937 resolutions voted	(2011:14,329;	2010: 12,153)
1,128 events	(2011: 1,170;	2010: 1,118)
934 companies	(2011: 961;	2010: 892)



Breakdown of how we voted on 13,937 global resolutions:

For	87.5%	12,199 res	(2011: 88%;	2010: 89%)
Against	5.6%	787 res	(2011:6%	2010: 4%)
Abstain	6.8%	951 res	(2011: 6%;	2010: 7%)

This represents “voting against management”⁹⁶ at least once at 54.9% (513/934) of companies during the year.

UK ONLY STATISTICS

USS voted 10,113 resolutions at 823 events at 654 UK companies in 2012 (including FTSE All Share, AIM, Fledgling and Plus market companies)

Breakdown of how we voted on 10,113 UK resolutions

For	93.0%	9,410 res	(2011:92.5%)
Against	2.8%	284 res	(2011:2.5%)
Abstain	4.1%	419 res	(2011:5%)

This represents “voting against management”⁹⁷ at least once at 341/823 UK events, and at 49.1% of companies (321/654) companies during the year.

15 March 2013

Supplementary written evidence submitted by Aberdeen Asset Management plc

INQUIRY ON THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING

You were kind enough to invite me to give evidence on 26 February at which time I undertook to follow up on a number of points raised during the session, including Aberdeen’s corporate governance process, company visits we undertake and the number of investment professionals in our UK/European equity team.

CORPORATE GOVERNANCE

Corporate governance and engagement are key components of our investment process in our active equity business. A review of the corporate governance practices of a potential investee company is part of our initial screening process and we only make an investment after we have conducted meetings with the management team. Once we have invested in a company, we hold regular meetings with management and board members to discuss strategic, operational, risk and governance matters and aim to visit companies in our core portfolios at least once a year but, in practice, it is often at least twice annually. Engagement is therefore embedded in our investment process which is reinforced with all voting decisions being taken by our investment managers.

⁹⁶ Includes against, abstain and withhold

⁹⁷ Includes against, abstain and withhold

By considering corporate governance as a key element of broader investment analysis, we avoid the box-ticking approach that ignores the particular circumstances of each company and prevailing market practice. With an equity investment process that emphasises investing for the long term, we feel that Aberdeen's funds will benefit from the gradual value creation that will result from a company's governance reforms over time.

One of the purposes of engagement is to encourage companies in which Aberdeen is an investor to strengthen their governance practices. Engagement with a company is most effective where it is built upon a long term relationship with the board and senior management, who are more likely to see Aberdeen as a credible and committed owner. Engagement is undertaken through a variety of formal and informal channels, ranging from participation in Annual General Meetings to private company meetings and formal correspondence. Engagement is complementary to both investment analysis and proxy voting because it allows Aberdeen to address specific governance concerns rather than simply divesting or voting against management without explanation. Where contentious issues arise in relation to motions put before a shareholders' meeting, Aberdeen will usually contact the management of the company to exchange views and give management the opportunity to articulate its position. If this approach proves unsatisfactory we may express our concerns through the company's advisers, discuss the issue with other shareholders or attend and speak at General Meetings.

COMPANY VISITS—NUMBER HELD

<i>Analysis of company meetings</i>		<i>12 months to 30 Sept 2012</i>	<i>12 months to 30 Sept 2011</i>
Regular company meetings lie at the core of our investment process and discussions may be wide ranging and cover strategic, operational and governance issues. Many of the meetings outlined in our Equity Engagement and Voting Report will have been initiated by Aberdeen but we welcome the increasing trend of chairmen, independent directors and chairmen of remuneration committees contacting us to discuss topical issues.	Asia ex-Japan	1,760	1,659
	Japan	248	229
	Emerging Markets	714	749
	North America	710	592
	UK	369	413
	Europe	315	176
	Total	4,116	3,818

ACTIVE EQUITY INVESTMENT

At the end of December 2012, we had over 95 active equity investment professionals, with 16 in the UK/European equity team. Globally, we have 2,045 employees, including over 500 investment professionals in total.

By way of background, I have also included copies of three documents we publish—the UK Stewardship Code, our Equity Engagement and Voting Report and Aberdeen's Corporate Governance Principles together with an analysis of proxy votes for UK companies (in the 12 months to 30 September 2012, Aberdeen voted over 9,000 resolutions at more than 700 shareholder meetings).

*Anne Richards
Chief Investment Officer
22 March 2013*

Supplementary written evidence from Government

Further to our recent telephone discussion noting the Committee's interest in the funding arrangements for the Law Commission's review of fiduciary duties, I am pleased to outline these in writing.

The project is additional to the agreed Law Commission work programme. BIS and the Department for Work and Pensions will therefore jointly provide to the Law Commission funds sufficient to meet the costs associated with the project, up to but not exceeding £90,000 for the financial year 2013–14, and £50,000 for the financial year 2014–15. The contribution will be divided equally between BIS and DWP, and will be payable quarterly in arrears on the Law Commission's invoice. Our expectation is that the total costs for the current financial year will be in the region of £75,000.

Alastair Cowie
Assistant Director, Corporate Governance
Department for Business Innovation and Skills

25 June 2013

Written evidence from the Financial Reporting Council

You asked how best to calculate the proportion of the UK market managed by signatories to the UK Stewardship Code.

The most recent data we have on this is from the IMA Stewardship Survey, which was published last month at <http://www.investmentuk.org/research/stewardship-survey/>

The IMA reported that the 103 respondents to this year's survey included 73 managers who are responsible for £702 Billion of UK equities representing 36% of the UK market.

As we discussed, the Code currently has 283 signatories, which comprises 203 Asset Managers, 67 Asset Owners and 14 Service Providers (1 organisation is listed as both an asset manager and a service provider). Given not all signatories responded to the IMA survey, although most of the largest managers did respond, it would therefore be reasonable to say the overall total is slightly higher than the IMA's figure.

Jocelyn Brown
Corporate Governance Adviser
Codes & Standards Division

11 July 2013

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House of Commons

Business, Innovation and Skills
Committee

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Third Report of Session 2013–14



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Committee

The Kay Review of UK Equity Markets and Long-Term Decision Making

Third Report of Session 2013–14

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written evidence*

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Business, Innovation and Skills Committee

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The Reports of the Committee, the formal minutes relating to that report, oral evidence taken and some or all written evidence are available in a printed volume. Additional written evidence may be published on the internet only.

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Contacts

All correspondence should be addressed to the Clerk of the Business, Innovation and Skills Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5777; the Committee's email address is biscom@parliament.uk

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Summary

The UK equity market

In 2010, only 11.5 per cent of UK shares were owned directly by individuals. In the early 1960s this figure was as high as 54 per cent. The major investment decisions which affect British companies are now taken by asset fund managers around the world who work for firms which control billions, often trillions, of pounds. We have heard that the rise of the institutional investor and the growth of intermediaries has been accompanied by a shift from 'owning' to 'trading'. The structure of the equity market has changed beyond recognition over the past few decades and regulation has not kept pace with it. Furthermore, there is a growing concern that asset managers do not behave in a way that benefits the long-term health of the companies in which they invest. At the heart of the issue is the incentives connected to the different links in the investment chain; from the owner, to the fund manager, through to the executives of the companies themselves.

The Kay review

Professor Kay's review of the UK equity market sought to improve long-termism in the market and to address the relationship between owners and fund managers. Currently this relationship is defined by short-term measurement of success at every stage. Players are encouraged to think ahead by only months, weeks or even days. Fund managers are expected to produce tangible results in very little time. This is as a direct result of the way the success of such managers is gauged. Fund manager pay and bonuses are benchmarked against the performance of other managers on a short-term basis and this feeds through to the information and behaviour expected of company executives. We make clear recommendations for the Government to bring about a cultural change in the incentives driving fund-manager behaviour to and develop a set of longer-term measures of success.

Mergers and acquisitions

Professor Kay's remit also included the issue of mergers and acquisitions, an area that our Committee has often reported on. Professor Kay recommended that the Government should take a more 'sceptical' view of the benefits of large takeovers and should be much more proactive in its monitoring of such activity. We recommend that the Government goes further. It should publish an assessment of the take-over regimes of other similar economies to learn about the impact that takeovers have had on their companies and economies; clarify what actions it will take over the next six months to be in a position to effectively monitor all merger activity in the UK; and produce a feasibility study which clearly outlines the risks and benefits of introducing a policy that will differentiate the voting rights of long-term owners and short-term traders during a takeover.

Financial Transaction Tax

The practice of High Frequency Trading (HFT) and the fact that shares are now traded and held for a matter of milliseconds epitomises the challenges faced in regulating the market. While there was support for such a Financial Transaction Tax, concerns were raised about

the practicality of implementing such a tax unilaterally. We recommend that the Government considers the viability, benefits and risks of a Financial Transaction Tax on HFT with the objective of changing the behaviour of very short-term investors.

Commitment to change

Professor Kay published his final Report in July 2012 and we have scrutinised both his Report and the Government's response to it. This Report follows in the wake of previous Reviews, particularly the work of Lord Myners in 2001. It is a huge disappointment that previous Governments have not implemented the recommendations of previous works nor have they kept regulation in line with the rapidly changing nature of equity investment. There is no point in commissioning a Review of the industry unless the Government is challenged to move forward and make radical changes to align the incentives facing every link in the investment chain. The Government has to deliver on the recommendations made by Professor Kay and the issues raised by his analysis. It must bring forward proposals to enhance the culture of long-termism, transparency and accountability.

1 Introduction

Our inquiry

1. In June 2011, the Secretary of State for Business, Innovation and Skills asked the renowned economist Professor Kay to review whether equity markets in the UK gave sufficient support to the key objectives of developing British companies' capacity for innovation, brands and reputation and the skills of their workforce. Professor Kay published his final Report in July 2012 titled the *Kay Review of UK equity markets and long-term decision making*. The Government Response was then published in November 2012. On 12 December 2012, we asked for submissions of evidence on the recommendations set out in the Kay Review and the Government's plans for their implementation.

2. We took evidence from seven panels:

- Professor John Kay, Chair of the Review of UK Equity Market and Long-Term Decision Making
- The Lord Myners CBE
- Catherine Howarth, Chief Executive Officer, FairPensions (now ShareAction), Christine Berry, Head of Policy and Research, FairPensions (now ShareAction), Simon Wong, Visiting Fellow, LSE and Partner, Governance for Owners, and Dr Paul Woolley, Head of the Paul Woolley Centre for the Study of Capital Market Dysfunctionalities
- Dominic Rossi, Global Chief Investment Officer, Fidelity Worldwide, Anne Richards, Global Chief Investment Officer, Aberdeen Asset Management, Harlan Zimmerman, Senior Partner, Cevian Capital, and Roger Gray, Chief Investment Officer, Universities Superannuation Scheme
- Anita Skipper, Corporate Governance Adviser, Aviva Investors, Steve Waygood, Chief Responsible Investment Officer, Aviva Investors, Neil Woodford, Head of UK Equities, Invesco Perpetual, and Chris Hitchen, Member of Kay Advisory Board Team and Chief Executive, Railpen
- Daniel Godfrey, Chief Executive, Investment Management Association, Guy Sears, Director, Institutional, Investment Management Association, Penny Shepherd, then Chief Executive, UK Sustainable Investment and Finance Association,¹ and Matthew Fell, Director of Competitive Markets, Confederation of British Industry
- Rt Hon Vince Cable MP, Secretary of State for Business, Innovation and Skills

We are grateful to all witnesses for their contributions to this inquiry and to all those who submitted written evidence.

¹ Penny Shepherd stepped down as Chief Executive of UKSIF in May 2013. She was succeeded by Simon Howard. Mr Howard has had opportunity to review the evidence that Ms Shepherd presented; which continues to represent the views of UKSIF.

The Government told us that the Kay Review was not a “list of detailed reforms” but rather “a framework for further work”.² This did not entirely tally with Professor Kay’s outlook; he said that the Review should “deliver the improvements to equity markets necessary to support sustainable long-term value creation by British Companies”.³ This remains to be seen, but it was clear that both Professor Kay and the Department agreed that “a sustained commitment to reform from Government, regulators and market participants” was needed to successfully reform the equity markets to the benefit of both its users and the economy as a whole.⁴

2 Ev 86

3 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 9

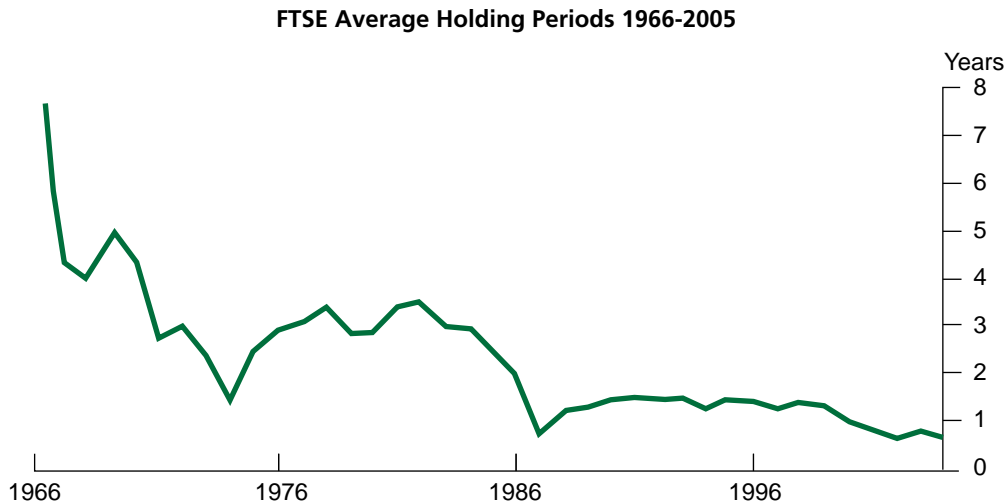
4 Ev 86

2 Background

Structure of the equity market

3. The rise of the institutional investor has been a significant evolution of the equity market in past few years. However, it has been accompanied by, and often linked to a decline in engagement and a rise in both short-termism and foreign owners. To understand the structure of the equity market, Aviva plc cited evidence about the rise in short-termism:

The Bank of England's Andrew Haldane has highlighted the sharp decline in average holding periods for UK equities since the mid-60s from a period of almost 8 years to just 7½ months in 2007, a trend that is reflected in the US and other international equity markets:



About two thirds of the turnover in UK equities is accounted for by hedge funds and high frequency traders.⁵

4. The market has been so distorted and complicated, the phrase ‘owner’ is no longer clear in its usage. Indeed, Professor Kay writes:

The term “share ownership” is often used, but the word “ownership” must be used with care. It is necessary to distinguish:

- Whose name is on the share register?
- For whose benefit are the shares held?
- Who makes the decision to buy or hold a particular stock?
- Who effectively determines how the votes associated with a shareholding should be cast?
- Who holds the economic interest in the security?⁶

5 Ev 99–100

6 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 3.12

5. The decline in individual investors has also been accompanied not only by a rise in institutional shareholders but also by a significant rise in foreign owners of UK equities. In 1963 only seven per cent of UK equities were held by owners outside of the UK. In 2010 that figure had risen to 41.2 per cent.⁷

Shareholder engagement

6. At the heart of Professor Kay's Review of the market was the question of engagement by shareholders. However, as he said in his Review, this is not simply a matter of volume:

The issue that concerns us is not whether there is too much or too little shareholder engagement. [...] Shareholder engagement is neither good nor bad in itself: it is the character and quality of that engagement that matters.⁸

7. Our witnesses from the sector agreed with this principle but argued that good engagement was hard to define. For example, Harlan Zimmerman, Senior Partner at Cevian Capital, was keen to point out the common mistake of confusing 'engagement' with 'voting':

[Voting] is a form of engagement that is very measurable, but it is not necessarily very meaningful if the objective is to steward the companies and improve them, as opposed to stopping them from doing bad things.⁹

This view was echoed by Neil Woodford, Head of UK equities at Invesco Perpetual:

There can be a disproportionate focus on voting as representative of your corporate engagement. In the environment that I experience day to day in the UK, corporate engagement is a bit like an iceberg. The bit that you can see above the surface is your voting record, but the vast bulk of your engagement is actually below the surface. It is not obvious how you engage or when you are engaging.¹⁰

He went on to explain that successful reform would be achieved only when shareholders voted with their voices and not with their feet, by acting like 'owners' not 'traders':

If you believe that at the first disappointing piece of news or the first opportunity you can exit the shares and move on to something else, then you will never think like an owner, and therefore you will not be actively engaged with that business. Ownership is crucial—a sense of ownership on behalf of obviously the asset owners as well as the asset manager.¹¹

8. Dr Paul Woolley, Head of the Paul Woolley Centre for the Study of Capital Market Dysfunctionality, took a slightly different stance. He told us that in order for the Kay Review to be considered a success, the recommendations that came out of it needed to

7 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 31, table 1

8 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 1.30

9 Q 191

10 Q 226

11 Q 241

achieve a shortening of the investment chain in order to “tackle the issue of too many intermediaries between savers and the assets they own, and the cost of those layers”.¹² The Chartered Institute of Personnel and Development agreed and linked the growing number of intermediaries and increased complexity within the investment chain to a recent “nosedive” in “public opinion of big businesses”.¹³

12 Ev 165

13 Ev 137

3 Previous review of the market

9. The commissioning of the Kay Review was not the first attempt by a Government to examine and reform the UK equity market. In 2001, Lord Myners published his *Review of Institutional Investment in the United Kingdom* (the Myners Review).

10. In the introduction to that Review, Lord Myners gave the following description of his work:

The review does not seek to argue that the institutions whose investment behaviour it examines have some public interest responsibility to invest in certain ways. But it is a legitimate issue of policy concern to establish the extent to which institutions' approaches to investment decisions are:

- rational;
- well-informed;
- subject to the correct incentives; and
- as far as possible, undistorted.

The review also has a specific remit to investigate institutional investment in private equity, but its purpose in doing so is to determine whether there are unnecessary barriers to such investment which should be removed, not to promote such investment regardless of whether it is right for the institution concerned. Indeed, a sudden move by pension funds to increase their allocation to private equity without proper consideration and analysis would be both damaging to them and contrary to the spirit of the review's recommendations. Private equity requires a sustained long-term approach, not rapid entry and exit driven by short-term performance results or changing fashion.¹⁴

11. Lord Myners told us that the Kay Review was “very well argued” and identified the core issue which was “the emergence over the last 30 years of a transactional relationship between companies, investors and intermediaries, and the dominance of the financial intermediaries, matched by a steady erosion of trust as the basis for commercial relationships”.¹⁵ However he went on to argue that without Government action the Review would have little impact on the sector:

I do not think that the Professor's report will add a jot or tittle to the prosperity of the UK economy and the success of our businesses.[...] The industry's response to Kay is, I think, one of considerable comfort. It might be summed up with: “Move along, Sir. Nothing much to look at here”.¹⁶

12. Lord Myners made more than 50 recommendations to the then Government to implement change. However, little progress was made in the implementation of those

14 Lord Myners, *Myners Review of institutional investment: Final Report*, March 2001, page 4, para 5

15 Q 83

16 Q 83

recommendations. Lord Myners argued that the reason for this was that the Government had simply lacked the resolve to act:

I am very disappointed in the lack of progress after my report on institutional investment in 2001. It relied on the same statements on principles of best practice that Kay is continuing to rely on. I have come to the conclusion that there are some fundamental flaws in our current approach to corporate ownership.¹⁷

He went on to remind us that “there is a long succession of reports on these areas” and that “there is very little in Kay’s early chapters that represent any fresh and additional perspective on these issues”.¹⁸

13. Professor Kay’s remit appears to support that lack of progress. We asked the Secretary of State for assurances that the Government would act on the Kay Review. Although the Secretary of State acknowledged that “there is always a danger of nice reports that just never happen”,¹⁹ he assured us that this would not be the case with the Kay Review:

We are not letting the matter rest. [...] We have made it very clear that in the summer or autumn of 2014 we want to go back over what the Kay Review has recommended to make sure that these things are actually happening. We are also commissioning a group of independent people who will track these recommendations and see that they are being followed through.²⁰

14. In the 12 years since the Myners Review, little has changed in the role and actions of institutional shareholders. The recommendations and findings of the Kay Review cannot be ignored or diluted as we have heard the Myners Review was. The similarities between the remit of the Kay review and that of the Myners Review demonstrate that little progress has been made to reform the sector. It is therefore critical that they do not share a similar fate. The Government must play an active role to drive reform on implementation of Professor Kay’s recommendations. Our Report, therefore, concentrates on where that activity must take place.

17 Q 84

18 Q 84

19 Q 314

20 Q 314

4 Professor Kay's recommendations and implementation

Investors Forum

15. Professor Kay recommended:

An investors' forum should be established to facilitate collective engagement by investors in UK companies.²¹

He elaborated that he saw the Forum as an opportunity for collective action to help "improve the performance of a company". He concluded that "the more opportunity there is for people who collectively own 30, 40 or 50 per cent of the company to act together, the more offset we have against that particular freerider issue".²²

In its response to the Review, the Government accepted this recommendation:

The Government intends to ask a small group of respected senior figures from business and the investment industry to review industry progress, including that made by institutional investors on shareholder engagement, both collectively and individually, and to assess companies' perception of the extent and quality of this engagement. This review will complement the Government's progress report in summer 2014.²³

16. Daniel Godfrey, of the Investment Management Association, told us that the Forum could produce benefits in terms of sharing stewardship resources and combating over-diversification of portfolios:

The investors' forum could potentially be a way of helping with [over diversification]. I recognise that it is very hard to get a consensus amongst investors. [...] There are examples, for instance in Holland, of where organisations come together effectively to syndicate from the buy-side their research on stewardship and engagement and governance, so that you can spread the load across a broad number of investors.²⁴

17. BlackRock, which was in favour of the Forum in principle, outlined three challenges and principles that should be put in place alongside the Forum to ensure its success:

1. The new forum needs to cover topics/issues that go beyond the typical discussions currently conducted through the existing industry.

21 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 51, rec 3

22 Q 30

23 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.18

24 Q 281

2. The forum’s governance policies need to ensure confidentiality of the meetings and views expressed as this aspect will be the key determining factor of the forum’s effectiveness and ultimate success.
3. The governance policies and terms of reference also need to be designed to allow effective actions in a way which does not conflict with rules on market abuse and acting as concert party in view of a takeover bid.²⁵

18. A number of our witnesses saw practical difficulties in creating a successful Forum. Despite the positives noises from the Investment Management Association, several witnesses argued that there was no need for the Forum, as there were already other investor groups in place. For example, FairPensions (now ShareAction) told us that “it is unclear how this initiative will differ from previous and existing investor bodies, such as the Institutional Shareholders Committee”.²⁶

19. Standard and Chartered Bank argued for a cautious approach in setting the remit for any new Investor Forum:

Any new rules regarding Investor Forum membership, meetings, engagement, communication, reporting and rights would need to be carefully constructed to ensure that it is complementary to existing investor communication methods and does not replace the existing and highly successful Investor Relations activity.²⁷

The Association of General Counsel and Company Secretaries of the FTSE 100 also took a sceptical view, arguing that there was “nothing to prevent interested parties from establishing such forums now, which leads us to question whether there is really a need for this type of body”.²⁸

20. Neil Woodford questioned whether asset managers would take part in such a Forum:

Investors are not good at coming together and talking about investment issues. Corraling investors is a bit like herding cats. It is very difficult to get investors even to agree to meet on a particular subject, even if it is particularly egregious.²⁹

Furthermore, Chris Hitchen, of USS Investment, pointed out to us that investment managers were “scared to meet, because the FSA or Takeover Panel might be suspicious”.³⁰ Steve Waygood, from Aviva Investors, told us that collaboration of investors through a forum would not necessarily produce results, and would need monitoring and proper resource:

25 Ev 129

26 Ev 112

27 Ev 88

28 Ev 116

29 Q 244

30 Q 244

There is nothing de facto about a forum that means that collaboration will be more effective or efficient and lead to better portfolio decisions. Fora can be extremely bureaucratic and ossify our ability to engage; they do not always necessarily work well. The ones that work well are the ones that are well resourced.³¹

21. Albion Ventures LLP argued that individual shareholders should not be given a collectivised voice as it believed that “solidarity amongst investors was unnecessary and may even weaken the strength of the shareholder system, namely that shareholders vote and act as individuals”.³² This opinion was disputed, however, by Christine Berry of FairPensions (now ShareAction) who told us that any Investor Forum “would need to include representation from asset owners as well as asset managers”.³³ She went on to argue that it must not become “just another vehicle dominated and run by the trade associations, which would be very similar to the vehicles we already have”.³⁴ Lord Myners shared this view, and clearly told us that if the Forum became “dominated by trade associations” then it would undermine the whole purpose behind the Review, because “trade associations’ modus operandi is to protect the status quo. It is not to change things”.³⁵

22. Penny Shepherd, Chief Executive of the UK Sustainable Investment and Finance Association (UKSIF), set out the three key groups which needed to be involved:

Active managers of equities. As you say, they may be structured in different ways, but essentially they are people who make buy and sell decisions.

Engagement specialists who are engaging on behalf of passively tracked funds, so on behalf of index-tracked funds.

Asset owners have commissioned independent service providers to engage with companies on their behalf.³⁶

23. When we questioned the Secretary of State on the role and remit of the Forum and how it would counter the risks illustrated by the industry, he gave a hands-off response:

We do not have a departmental remit telling them what we think they should do; we think Kay gives enough guidance on that.³⁷

He went on to tell us that this approach also extended to funding:

We have envisaged that this is something the industry should be doing in its own interests and it should fund it. There has been an issue about levies. [...] There is an

31 Q 246

32 Ev 91

33 Q 148

34 Q 148

35 Q 83

36 Q 295 [extracts]

37 Q 339

issue about how they charge their members for it and how transparent that charge is.³⁸

24. The IMA, alongside the Association of British Insurers and the National Association of Pension Funds, have accepted the challenge to establish the Investor Forum. They have stated that the next stage of implementation is to set up a working group to consider practicalities and issues surrounding the Forum, which would report later this year:

The intention is to appoint the working group by the end of April and to ask it to report in the Autumn with any recommendations as to how collective engagement might be enhanced to make a positive difference.³⁹

25. The IMA has confirmed that this timetable stands and that the working group will report its findings by the end of November 2013.⁴⁰ We received evidence expressing frustration that this seemingly simple and specific recommendation had not been implemented so long after it was accepted. Lord Myners told us that:

I have often found in my professional career, and also in the work I have done on reviews, that I have been given too much time. I am now a great fan of saying, “Let’s get these reviews done quickly. You will get 90% of the answers in 30 days. You may get the last 10% if you make it 300 days.” That is why, if I were the Secretary of State, I [...] would have had that investment forum up and running.⁴¹

26. We put the criticism to the Secretary of State that, despite the recommendation being accepted in the Autumn of 2012, the Forum remained in concept form only. The Secretary of State conceded that that was “a fair criticism”,⁴² but gave the following warning:

If the forum has not happened in the autumn, when this steering group reports, I think you would have good grounds for coming to me and saying, “Why aren’t you chivvying these people along? The report’s been out there for a year or so. Why is nothing happening?” That would be perfectly legitimate.⁴³

27. We agree with Professor Kay and the Government that collective engagement is to the benefit of the equity market and UK businesses. However, we are concerned that the hands-off approach taken by the Government runs the risk that progress will stall. The Government has provided no remit, deadline or resource for the Investor’s Forum and the ‘working group’ to investigate the concept of the Investor’s Forum will not report until later in 2013. The Government has told us that it will publish an update on progress in the summer of 2014. We recommend that the Government outlines a clear timetable for

38 Q 343

39 Investment Management Association website, *Press release 26 March 2013: Investors to work together on collective engagement* [accessed 21 June 2013]

40 Investment Management Association website, *Investor Working Group on Collective Engagement* [accessed 11 July 2013]

41 Q 94

42 Q 342

43 Q 342

setting up the Forum before that point, engaging with different types of investors, along with milestones and assigned responsibilities for achieving this.

Fiduciary duty

28. Professor Kay summarised his analysis on the topic of fiduciary duty and his interpretation of its current definition in the following terms:

Case law identifies a fiduciary as ‘someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence’.⁴⁴

However, he believed that a greater focus needed to be placed on the principles of loyalty and prudence, rather than the technical legal interpretation as it stood:

Loyalty means putting the client’s interest first, and prudence, which relates to both clients’ interest and conflict, is essentially about doing what you would do yourself if you were in the position of the client.⁴⁵

29. Professor Kay went on to outline his expectations for a new definition. He told us that he had two minimum expectations. Firstly:

That anyone who is engaged, either in advice or in discretionary activity of some kind, accepts the obligation to put the client’s interests first, ahead of his or her own.

The second is that conflicts of interest should be avoided, and should be disclosed where they are not avoided. There should be a requirement not to profit as a result of the existence of the conflict of interest. I think that these are the minimum standards, and in my view, I do not want to distinguish between wholesale and retail markets in the application of these.⁴⁶

With respect to fiduciary duty, Professor Kay recommended that the Law Commission should “review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers”.⁴⁷

30. The Government accepted this recommendation and the Law Commission has taken on the project:

In broad terms [the Government] ask us to set out what the current law requires pension trustees, investment managers and other financial intermediaries to consider in deciding an investment strategy. In particular, do fiduciary duties apply to all those in the investment chain? And how far must fiduciaries focus exclusively on maximising financial return, to the exclusion of other factors?

44 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 9.3

45 Q 57

46 Q 56

47 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 69, rec 9

We are not asked to look at the law in isolation. Instead, the project will consult stakeholders about their understating of the law and how it impacts on them.

Next we will evaluate the law according to a variety of criteria. In particular, is the law sufficiently certain? And does it do enough to encourage long-term investment strategies? If we think changes are needed we will make broad recommendations for reform. However, we have not been asked to draft legislation.⁴⁸

31. Christine Berry, Head of Policy and Research at FairPensions (now ShareAction), was “supportive” of the Law Commission’s work to clarify the definition, but she stressed that “we should not assume that at the end of the process it will be sufficient just for the Law Commission to pronounce that “this is what we think the law is”, and it will change behaviour”.⁴⁹

32. The Law Commission has announced that it “will publish a consultation paper by October 2013”.⁵⁰ After analysing the responses, it plans to “publish a final report with our recommendations by June 2014”.⁵¹ We were concerned that the timetable lacked any urgency.

33. Tomorrow’s Company told us that “fiduciary duty is not well understood by pension fund trustees and needs to be appropriately and more widely interpreted”.⁵² The Investment Management Association told us that “asking the Law Commission to undertake such a review will mean that it will be subject to an open and transparent consultation process”.⁵³ However, it went on to warn us that “fiduciary principles at law may not be capable of exact definition”.⁵⁴ BlackRock, on the other hand, rejected Professor Kay’s findings and told us that the rules around fiduciary duty were “sufficiently well understood under English law”:

We believe that UK asset managers understand their obligations, which include contractual (setting the scope of who a manager’s customer is, the guidelines to be applied, etc.) and regulatory (both at an EU or UK level) duties. These are high standards already.⁵⁵

34. We also heard evidence that the lack of clarification is having a material impact on the stewardship of firms and the investment behaviour (in terms of short or long-term outlook) of fund managers. FairPensions (now ShareAction) argued that this lack of clarity resulted in investment managers being discouraged from taking a long-term or progressive

48 The Law Commission, *Fiduciary Duties of investment intermediaries: Initial questions*, March 2013, paras 1.5–1.6 & 1.10–1.12

49 Q 161

50 Law Commission website, *Fiduciary Duties of Investment Intermediaries* [accessed 21 June 2013]

51 Law Commission website, *Fiduciary Duties of Investment Intermediaries* [accessed 21 June 2013]

52 Ev 145

53 Ev 150

54 Ev 158

55 Ev 130

approach to the companies in which they invest and that this needed to change as a matter of urgency.⁵⁶

35. When we questioned the Department, it told us that:

The project is additional to the agreed Law Commission work programme. BIS and the Department for Work and Pensions will therefore jointly provide to the Law Commission funds sufficient to meet the costs associated with the project, up to but not exceeding £90,000 for the financial year 2013–14 and £50,000 for the financial year 2014–15. The contribution will be divided equally between BIS and DWP, and will be payable quarterly in arrears on the Law Commission’s invoice.⁵⁷

It went on to assure us that the Departments’ expectation was that “the total costs for the current financial year will be in the region of £75,000”.⁵⁸ The Secretary of State confirmed that he had not attached any timescale to the Law Commission’s work:

We have not set a deadline, but I have specifically asked that they deal with this expeditiously and get a move on, precisely because of the suspicion that I had already heard, which you have expressed very well. We do want some answers quickly. The problem about taking shortcuts on complex, legal questions is that the outcome is then disputed.⁵⁹

However, he agreed that it was “frustrating” and “would much rather we had some quick results with some of these things”.⁶⁰

36. The Law Commission is currently consulting on the legal definition of fiduciary duty and will not report back until June 2014. We believe that this is too slow. We recommend that the Government liaises with the Law Commission to bring forward the timing of this project. The Government is paying up to £140,000 for this project and we expect it to push for the highest value for the taxpayer’s money. The Law Commission will launch a three month consultation in October 2013. We suggest that it gives this issue the appropriate priority and publishes its final definition in the first quarter of 2014.

Appointment of executives

37. Professor Kay recommended that:

Companies should consult their major long-term investors over major board appointments.⁶¹

56 Ex 109

57 Ev 170

58 Ev 170

59 Q 348

60 Q 348

61 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 63, rec 5

In making this recommendation, Professor Kay said that it was targeted at “major board appointments” and that for smaller companies “it would probably be primarily about the chairman and chief executive”.⁶²

He also clarified that he would apply this recommendation to the “six to 10 large asset managers who are now speaking for a very large proportion of UK equities”.⁶³ The Government accepted this recommendation:

The Government agrees with the Kay Report that efforts by companies to consult their shareholders in advance of making major appointments to the board is consistent with developing long-term trust-based relationships that support engagement in pursuit of sustainable value creation.⁶⁴

It went on to connect this recommendation to the Investor’s Forum:

The establishment of an investor forum, as suggested by Professor Kay, may provide a means for such consultation to take place, but it need not be the only means. Many companies already consult shareholders on board appointments in the context of wider engagement activity and this is to be welcomed.⁶⁵

38. Several witnesses indicated that this recommendation was unnecessary as the practice already took place. Aberdeen Asset Management plc told us that it already held “regular meetings with management and board members to discuss strategic, operational, risk and governance matters”.⁶⁶ As an investor, it aimed to visit companies at least once a year “but, in practice, it is often at least twice annually”.⁶⁷ The Investment Management Association told us that many asset managers were already specifically consulted on major board appointments:

This already happens and investors welcome it particularly when a company is considering changes at a time when the company concerned is in difficulty or to key roles such as chairman or chief executive.⁶⁸

39. Other asset managers, however, corroborated Professor Kay’s view that “asset managers would say that they did not really have the expertise to do this”.⁶⁹ Neil Woodford confirmed that he did not feel that the role of the fund manager was “to tell companies how to run their businesses”.⁷⁰ He took the argument a stage further by telling us that Professor

62 Q 38

63 Q 37

64 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.28

65 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.28

66 Ev 169

67 Ev 169

68 Ev 148

69 Q 40

70 Q 219

Kay's recommendation would actually damage performance and that "boards would become dysfunctional if all their fund managers were trying to chip in and tell them how to run their business".⁷¹ Lord Myners concurred. He questioned why asset managers should be consulted on such decisions, given that they had no business experience:

I would like to question whether the idea that fund managers should talk to companies about strategy, organisation and incentive would actually be testing them on issues where they have a competence. Most fund managers have not done anything other than work in the City, in fund management. They have never run a business.⁷²

Professor Kay acknowledged this concern but expressed his hope that, over time, asset managers would gain the expertise to carry out this objective.⁷³

40. Other witnesses told us that, qualified or not, fund managers would not want to be involved in these decisions because it would mean becoming an 'insider' which could create a conflict of interest. This would restrict such a manager from trading his or her shares. To us, this is an illustration of the dysfunctional relationship created by the role of asset managers. The fact that managers represent the owners of shares but do not want to take responsibility for the ownership of the companies summarises the heart of the issue. The Association of General Counsel and Company Secretaries of the FTSE 100 summarised the problem:

Information about individual appointments, particularly for senior or executive directors, may constitute price-sensitive information about a company. The disclosure (or delay in disclosure) and the dissemination of such information is therefore subject to significant regulatory constraints. If the information is considered to be inside information, the investor would need to be wall crossed prior to any discussions. This may be problematic as, in our experience; institutional investors are unlikely to agree to this if discussions are continuing for any period of weeks, as they would be prevented from dealing for a prolonged period of time.⁷⁴

41. Lord Myners characterised institutional investors as saying "we don't like being made insiders" because "we don't like to give up our right to deal".⁷⁵ Lord Myners expressed dissatisfaction that this was the case but told us that as it stands, Professor Kay's recommendation was simply not practical:

The right approach [...] is to say "we relish the opportunity of being insiders. We would like to be insiders. If that means we can't deal for a month or so, that's neither here nor there if we get the chance to have a voice".⁷⁶

71 Q 219

72 Q 129

73 Q 40

74 Ev 117

75 Q 107

76 Q 107

42. Albion Ventures took a different view. It told us that consultation of major shareholders was a start, but that Professor Kay had not gone far enough. It recommended that “long-term substantial shareholders should have representation on the boards of companies in which they invest”.⁷⁷ It argued that this would “allow longstanding investors to have personal, reciprocal and trust-based relationships with the company management”.⁷⁸ We asked Harlan Zimmerman, Senior Partner at Cevian Capital, how the current appointment system could be improved and how external forces should influence the decision. He told us that it was not necessary for shareholders to be represented on the boards of companies because the non-executive directors were supposed to be fulfilling that role. However, he went on to explain that the role of non-executive directors had been ignored and described the fact that this was overlooked by Professor Kay as being “the single biggest problem” with the Review:

Fidelity, even with the best will in the world, cannot look after the day-to-day operations of thousands of companies, so we have non-executive directors who are there, who are supposed to be doing that job for us.

Now, the companies will say they do consult with their major shareholders on non-execs, and the asset managers will say that they do consult as well, but the reality is that when that happens it is a very superficial consultation in most cases. It very often takes the form of a Sunday night call before an announcement on Monday. If you look at one single damning fact, director elections here in the UK for non-executives are a rubber-stamping exercise.⁷⁹

43. Professor Kay has provided a clear recommendation, proposing that companies consult with major investors over all board appointments and the Government has agreed to implement this. We therefore recommend that the Government publishes a timetable for the implementation of this policy, clarifies which investors companies are to consult with and outlines how it intends to combat the issues surrounding insider trading and confidentiality which inevitably accompany such board appointments. Alongside this, the Government should undertake an impact assessment, particularly looking at the possible increase of bureaucratic burdens on small businesses and, if necessary, introduce an opt-out clause for them.

Remuneration of executives

44. Professor Kay recommended:

Companies should structure directors’ remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives

77 Ev 90

78 Ev 90

79 Q 201

should be provided only in the form of company shares to be held at least until after the executive has retired from the business.⁸⁰

When he spoke to us, he outlined his vision for the principles underlying this recommendation:

What I want to see is people running large British companies whose primary motivation is that they want to build great British businesses.⁸¹

45. The Government accepted the principle behind the recommendation but not any specific role in its implementation. It did, however, refer to work it was already undertaking to reform the governance processes behind executive pay:

The Government agrees that the structure of remuneration should be determined by individual companies in consultation with their shareholders and that agreeing and sharing good practice is the appropriate way to promote change in this area. The Government does not believe there is a case for blanket regulation of the structure of company directors' remuneration and believes that companies and their shareholders need flexibility to negotiate outcomes that work for them. The Government's comprehensive reforms to the governance framework for directors' remuneration will help to support change in this area.⁸²

46. The Government was also positive in its support of Professor Kay's ideas for performance incentives to come in the form of shares which would be held until the executive had left. However it stopped short of implementing this recommendation, instead stating that this could be achieved through "good practice" rather than through state intervention:

The Government believes that Professor Kay's prescription for long-term incentives—that these should be in the form of shares to be held beyond the individuals' departure from the company—is an idea which companies should actively consider.⁸³

47. We received a significant body of evidence on this recommendation. The National Association of Pension Funds Limited agreed with Professor Kay that "the best form of alignment between executives and shareholders is the ownership of shares over the long-term".⁸⁴ Lord Myners agreed with the recommendation in principle, but cautioned us that it may not work in practice:

80 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 79, rec 15

81 Q 72

82 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.64

83 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.62

84 Ev 125

Conceptually, it is rather attractive, but it is wholly unenforceable. Logically, you would sell your interests through derivatives. You might leave the company in order to be able to sell.⁸⁵

He concluded that “a director can actually have too much of their wealth invested in the company. They become too obsessed with the share price”.⁸⁶ The Investment Management Association suggested a compromise to encourage positive behaviour through incentives. While they agreed with Lord Myners that requiring executives to hold the shares until after they had retired “could result in them leaving a company when they consider it the best time to realise those shares”,⁸⁷ they went on to assert that:

Investors want companies to have remuneration policies that are aligned with their interests such that they promote long-term value creation, take account of the fact that effecting change to a company’s strategy takes time, and mirror a company’s development cycle.⁸⁸

The IMA recommended that the current system used by many companies could be tweaked without the need for a change in regulation or austere shareholding requirements:

A suitable compromise between career shares and the current standard practise for three year Long-term Incentive Plans (LTIPs) would be five year LTIPs. There need not necessarily be a five year vesting period but at a minimum, there should be a period of at least five years between the date of grant of the award and any sale of shares.⁸⁹

48. Several of our witnesses agreed that, while shares were an effective way to connect executive pay to company performance, Professor Kay’s recommendation was something of a blunt tool. For example the Chartered Institute of Personnel and Development (CIPD) told us that the “focus on financial gain to the exclusion of other considerations has played a large part in distorting views of businesses’ purpose” and that performance should go “beyond the purely financial and how much profit is being generated”:

As well as generating profit, business leaders must show awareness of, and commitment to, longer-term stewardship responsibilities, as well as the leadership qualities required to take their workforce with them and drive sustained high performance. The measures used to determine pay of executives and the different reward components should be visible and open to external scrutiny.⁹⁰

49. Other experts agreed with the Government that there was no case for blanket regulation in this area. The Association of General Counsel and Company Secretaries of

85 Q 124

86 Q 124

87 Ev 152

88 Ev 151

89 Ev 152

90 Ev 137

the FTSE 100 stressed that any change to the executive pay regime had to preserve an element of flexibility. It withheld support for Professor Kay's recommendation and concluded that there could never be a "one size fits all" policy to achieve this.⁹¹ It wrote to us with four arguments against the compulsory implementation of Professor Kay's recommendation:

1. Such a policy is likely to make it considerably harder to attract good candidates. This is likely to be a particular issue for the many London-listed companies which have some or all of their operations and/or directors located outside the UK.
2. Directors have come to rely on the performance related pay and deferral for the length of time envisaged by the Recommendation may be impractical.
3. Such a policy may simply shift the emphasis from performance related pay to basic pay which could possibly mean that there is less incentive for management to pursue performance enhancing strategies.
4. Such a policy [may] encourage the early resignation of successful executives (to trigger release of their long-term incentive gains), leading to an increased 'churn' of executives, and thereby reducing long-term strategic focus.⁹²

50. Standard Chartered Bank also argued that Professor Kay's recommendation would distort the market and damage the leadership of British firms:

Making executives retain shares could in effect encourage the wrong behaviours like incentivising them to leave the organisation to realise value from their locked in holdings. [...] Executives nearing retirement could be tempted to take actions designed to drive up the share price in the short-term.⁹³

51. By contrast, the UK Sustainable Investment and Finance Association expressed frustration that the Government had not fully accepted this recommendation and that the Government had "yet to facilitate a deep and constructive debate specifically on incentives and pay within the investment chain".⁹⁴ We asked Professor Kay to comment on the Government response to this recommendation. He too expressed regret that his recommendation had apparently been sidestepped, and asserted that, because "people frequently do specific things they are incentivised to do", the current system of executive pay was incentivising the wrong behaviour and needed to change.⁹⁵ He believed that there was an argument for his recommendation to have been made compulsory.⁹⁶

91 Ev 118

92 Ev 118–119

93 Ev 89

94 Ev 142

95 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 11.5

96 Q 73

52. The Government has accepted the principles underlying Professor Kay's recommendation on the remuneration of executives. We are therefore disappointed that it has failed to take the action to see it put into practice or responsibility for its implementation. We are not persuaded by the Government's view that businesses will see the benefit of this recommendation and will adopt this measure voluntarily.

53. *We support the recommendation that company directors should be tied into the long-term performance of their companies through time-appropriate shares. Since the Government has accepted Professor Kay's analysis and agreed with his findings, it should reconsider its response and take an active approach to its implementation. In particular, we recommend that the Government outlines how it intends to combat the issue of directors using options and derivatives to avoid these rules. Alongside this the Government should outline how it will ensure that departing directors will not be perversely incentivised to artificially inflate the share price immediately prior to their retirement or retire early to realise the locked-in value of their shares.*

Incentivising fund managers

54. Professor Kay recommended:

Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund.⁹⁷

55. The Government accepted the principles underlying this recommendation:

Professor Kay's stated intention to shift the culture of asset manager pay through the development of industry good practice, rather than by imposing pay structures in regulation. Recommendation 16 is therefore reflected in the Kay Good Practice Statement for Asset Managers. The Government will encourage asset managers to adopt such models by promoting consideration of the Kay Good Practice Statement for Asset Managers.⁹⁸

56. With regard to current remuneration practices, Russell Investments agreed with Professor Kay's analysis. It stated that a short-term focus was "encouraged by the business models of asset managers who are generally incentivised to maximise the volume of assets they gather rather than focus on good, long-term outcomes for their investors".⁹⁹ It went on to tell us that owners tended to follow fashionable managers:

97 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 80, rec 16

98 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.68

99 Ev 97

A successful manager need only produce short bursts of good performance to attract assets and hence profits and then seek to avoid the sort of underperformance that would cause those assets to be lost.¹⁰⁰

57. The Investment Management Association took this further and told us that owners were not overly concerned with the remuneration of the managers they instructed because they were paid by the asset management firm, not by the client directly:

While the level of fees has an impact on performance, individuals are paid by the firm, not by the client, so that decisions about an individual's remuneration do not affect the cost to clients.¹⁰¹

It went on to warn us that too strict aligning of the performance of a manager's fund and remuneration "could encourage a portfolio manager to leave at a time when their particular fund is performing well for clients".¹⁰²

58. BlackRock was keen to highlight the fact that the current system of remuneration of asset managers often had performance incorporated. It told us that, for its managers, "compensation reflects investment performance over the short, medium and long-term and the success of the business or product area".¹⁰³ It went on to explain that "a limited number of investment professionals have a portion of their annual discretionary awarded as deferred cash that notionally tracks investment in selected products managed by the employee",¹⁰⁴ but it warned us that this could not be rolled out more widely because of global regulation:

Such co-investment is not always possible. For example, as a result of the significant compliance burden with respect to the US Foreign Account Tax Compliance Act (FATCA), a US national is generally precluded from investing in a UK fund.¹⁰⁵

Neil Woodford, Head of UK Equities in Invesco Perpetual, believed that incentive structures were "really important around performance measurement and the hiring and firing of fund managers".¹⁰⁶ It recommended that changing those structures to a longer term perspective would be "a very important step in encouraging longer term behaviour and more engagement".¹⁰⁷ Chris Hitchen, Chief Executive of RailPen, agreed. He drew on his experience in the pension industry to elaborate on how the definition of success for fund managers needed to be changed:

100 Ev 97

101 Ev 152

102 Ev 152

103 Ev 133

104 Ev 133

105 Ev 133

106 Q 249

107 Q 249

It would probably have to be more around, “Have you contributed real value to my pension schemes’ assets over many years?” rather than, “Have you beaten the market last quarter?”¹⁰⁸

59. Other witnesses brought up the issue of ‘tracking-error’. Dominic Rossi, Global Chief Investment Officer at Fidelity Worldwide, explained that “tracking error is a statistically based measure of the likely deviation of returns of the portfolio versus the specified benchmark”.¹⁰⁹ It is often used as a measure of success when investors chose which fund managers to trust their capital with. While it may be appealing to have some measureable way of tracking performance, Lord Myners explained that this was a somewhat blunt tool:

Most fund managers regard themselves as in some ways enslaved by [tracking error], and would say in their true hearts that they would rather be able to run a portfolio with a higher tracking error. [...] Kay does not get to grips with these things.¹¹⁰

Other witnesses told us that tracking error was partially responsible for the over diversification of portfolios. Harlan Zimmerman, Senior Partner at Cevian Capital, summarised this argument:

It forces the portfolios to be much, much greater than they need to be. [...] Many problems of the investment industry are encapsulated by the very phrase “tracking error”—it is the word “error.” [...] That is a root of many problems, as I say, because it causes over-diversification of portfolios and an inability to pay for resources necessary to work with them in a good way.¹¹¹

Lord Myners asserted that the industry was aware that current measures of performance simply did not give fund managers enough confidence to invest over the long-term for fear of appearing deficient compared to the short-term benchmark:

Most asset managers would welcome anything that encouraged them to believe that their clients would support them over a longer term; that their clients were less focussed on the very short-term; and that their clients were less focussed on how they did against the index.¹¹²

60. It was generally agreed that even when fund manager remuneration was linked to some measure of performance, the measure of performance was often short-term and set against inappropriate benchmarks. FairPensions (now ShareAction) wrote to us to summarise its research and proposed eight steps to align the incentives of investors and fund managers to the more long-term:

- Fund manager performance should be reviewed over longer time horizons than the typical quarterly cycle.

108 Q 249

109 Q 192

110 Q 127

111 Q 192

112 Q 127

- Excessive reliance on measuring performance relative to a market index should be reduced.
- Pension funds should have voting and engagement policies that should be integrated into the investment process.
- Shareowner activism should be given more weight in the selection and retention of fund managers and other matters.
- All advisors to institutional investors should have a duty to proactively raise ESG issues and encourage adherence to the Stewardship Code.
- Fund management contracts and fund managers' performance should include an evaluation of long-term ability to beat benchmarks.
- Investment consultants' fee structures should not reward them for moving clients between fund managers.
- Within companies the implementation of strong cultural norms should be supported by independent whistleblowing mechanisms, overseen by professional bodies who offer the whistleblower appropriate protection.¹¹³

Catherine Howarth, The Chief Executive Officer for FairPensions (now ShareAction) did temper this evidence with a call for simplicity:

There are huge risks in trying to be too clever with the remuneration of fund managers. [...] There is much more performance-related pay now in fund management. That brings a host of risks because, depending on the time frame involved, it will exacerbate the existing compulsion towards short-term trading in the emphasis of fund managers over long-term stewardship orientation.¹¹⁴

61. The Government has promised to “encourage asset managers to adopt such models [incorporating performance measures into the remuneration of fund managers] by promoting consideration of the Kay Good Practice Statement for Asset Managers”.¹¹⁵ However, it is not clear whether the Government is taking an active or passive role in this change.

62. The incentives driving the actions of fund managers are one of the most important factors within the investment chain. Professor Kay made a specific recommendation on this but the Government has shied away from accepting it, citing an unwillingness to prescribe pay structures. While this may be understandable, it is clear that the Government must be involved; at the very least encouraging a cultural shift away from short-term to long-term performance-based pay.

113 Ev 105–106 [extracts]

114 Q 142

115 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.68

63. *We recommend that the Government takes a harder line when framing the culture in which fund managers work by highlighting best practice where it sees it. We further recommend that it should work towards the goal that fund manager performance be reviewed over longer time horizons than the typical quarterly cycle.*

64. *One way that the Government can help effect a culture change in the incentives driving fund-manager behaviour is to develop and publish a set of long-term measures of success alongside options for sanctions for demonstrable failure. We recommend that it does so, and then annually publishes a list of those firms that have fully adopted such measures. This would provide a different measure of success to the very short-term ones which are currently available.*

Quarterly Reporting

65. In respect to company reporting, Professor Kay made two recommendations:

- i. Companies should seek to disengage from the process of managing short-term earnings expectations and announcements;¹¹⁶ and
- ii. Mandatory IMS (quarterly reporting) obligations should be removed.¹¹⁷

The Government accepted both recommendations and went on to clarify that, since the Kay Review had been commissioned, the European Commission had brought forward proposals to amend the Transparency Directive. Implementation of the recommendation removing quarterly reporting obligations would, therefore, be dependent of the successful passing of the amendment and upon negotiation with the EU:

The Government has already made clear its strong support for the [European] Commission's proposal [to amend the EU Transparency Directive] and will therefore take forward work to deliver this recommendation in the context of ongoing negotiations with the Commission and EU Member States.¹¹⁸

The initial assurances that the Government had apparently fully backed Professor Kay on this recommendation were somewhat dampened, however, when we read further down the government response. In that response, the Government went on to say that once the EU directive had been amended, any change would then depend on further consultation:

UK implementation of the proposed changes would fall to the FCA and be subject to consultation and cost-benefit analysis.¹¹⁹

66. Professor Kay told us that he had clarified his analysis behind the recommendation. He began by asserting that the idea that more information was always better was “not true”.¹²⁰

116 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 64, rec 6

117 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 74, rec 11

118 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.52

119 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.52

He found that “companies produce steady streams of reported quarterly earnings” which served to encourage those involved to think only from one quarter to another which potentially damaged the long-term performance of firms.¹²¹ He concluded that this should be replaced by “more qualitative relationships between the company and the asset manager”.¹²² Aviva plc took a similar view:

Such short-term reporting cycles contribute to short-term thinking and can discourage investment for the long-term, given the impact that could have on short-term performance.¹²³

67. Other experts agreed that the process of producing short-term (quarterly) reports had had a behavioural effect on the managers and investors both producing and reading them. BlackRock explained that:

Quarterly reporting does potentially place undue focus on short-term developments that may have little material impact over the longer term. Too frequent disclosure can make the market lose sight of the longer term objectives and judge the company on its short-term achievements. This, in turn, might make it more difficult for boards to focus on the long-term development of their business.¹²⁴

The Chartered Institute of Personnel and Development also believed that reporting on a quarterly basis may have acted as “a contributory factor to a short-term outlook on company performance”.¹²⁵

68. By contrast, Albion Ventures did not believe that quarterly reporting was at the heart of the problem:

While we accept that some quarterly reporting will contribute to short-sighted business practices when the content has been “managed” to appear in the most positive light, we do not believe that the procedure should be removed altogether.¹²⁶

It went on to explain that it was not the frequency of such reports that was the problem, but the content and that current reporting practices did not focus on the correct information. Specifically, companies should steer away from “marketing speak” and move towards “something much more balanced, objective and long-term minded”.¹²⁷ Dr Woolley, Head of the Paul Woolley Centre for the Study of Capital Market Dysfunctionality, also argued that there was “no merit” in reducing the flow of information and told us that “the quarterly reporting of pension fund returns should still go on”.¹²⁸

120 Q 65

121 Q 66

122 Q 66

123 Ev 104

124 Ev 130

125 Ev 139

126 Ev 104

127 Ev 90

128 Q 158

69. Finally, we were warned by the Association of General Counsel and Company Secretaries of the FTSE 100 that any changes in the UK (or Europe for that matter) will have a diminished effect because of the global nature of reporting standards:

For UK companies with international businesses, notably those with operations or listings in the US, there may still be a legal or regulatory requirement to report more frequently and/or in a way that engenders a short-term view.¹²⁹

70. We support Professor Kay’s recommendation that the requirement for quarterly reporting should be removed and recommend that the Government now outlines a clear timetable to implement this recommendation including what alternative strategies would be followed in the absence of any change in EU law.

71. We recommend that the Government sets out details of progress in negotiations with other international accounting standard bodies (such as the U.S. Securities and Exchange Commission) on the requirement for quarterly reporting to ensure that any changes made to the domestic or EU-wide accounting practices are accepted on a global level.

Narrative Reporting

72. Professor Kay recommended:

High quality, succinct narrative reporting should be strongly encouraged.¹³⁰

The Government accepted this recommendation:

The Government supports this recommendation. We are already focused on this policy objective, which was the subject of a Coalition Government commitment, and have carried out two consultation exercises in the past two years.¹³¹

The Government has stated that it will introduce regulations to “bring about the changes to the structure and format of reporting” and the intention is for these to come into effect by October 2013.¹³² The Government, in its response to the Review, went on to say that it would be “working closely with the Financial Reporting Council (FRC) as they develop the guidance on the new provisions”.¹³³

73. Professor Kay concluded that good reporting went against the instinct of most company directors:

129 Ev 118

130 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 74, rec 12

131 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.53

132 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.56

133 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.56

An annual report is not easy to read because its format is driven by regulatory requirements and those who write it often have little inclination or incentive to communicate information beyond that required to fulfil that obligation.¹³⁴

Daniel Godfrey, Chief Executive of the Investment Management Association, agreed:

The last place you would go if you wanted to find out about the company now, almost, is the report and accounts.¹³⁵

74. Lord Myners agreed, but took the issue further and told us that irrelevant information or an absence of information was less serious than misleading data. In particular, he agreed with Professor Kay's recommendation for narrative reporting:

In numbers, you can fudge all sorts of things. You can put apples with pears and call them lemons, and your auditors may well allow you to do that. It is when you come to express in words what is happening in the company that the directors get quite exercised about their legal liability if their statements are not full, clear and unlikely to be ambiguous.¹³⁶

75. Tomorrow's Company warned that, while they "strongly welcome" the recommendation and had "long argued" for such a change in regulation there was a "danger of overload".¹³⁷ It told us that this was because there were so many regulatory and market initiatives, changes and consultations throughout the world which focused on different aspects of reporting:

The proposals for narrative reporting need to be framed in a context which reinforces this coherence of approach by recognising the systemic nature of the corporate reporting system and the place of the specific reform in that wider context.¹³⁸

76. The Association of General Counsel and Company Secretaries agreed, stating that "it will be important to ensure that there is a 'joined-up' approach between all legislative and regulatory bodies".¹³⁹ It took this further and told us that domestic reporting standards would be ultimately ineffective when held against the reporting requirements of other countries'. It concluded that "any streamlining of the UK position would be undermined by US regulation which, generally, requires more detailed reporting".¹⁴⁰

77. Lord Myners, however, did not consider narrative reporting to be an onerous burden:

134 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 10.11

135 Q 301

136 Q 113

137 Ev 145

138 Ev 145

139 Ev 118

140 Ev 118

What would you want to know about the company in that 10-minute meeting every quarter? Write that down, and then compare it with what you tell your shareholders, and try to reconcile why there is such a huge difference between the two.¹⁴¹

78. We recommend that the Government sets out how it will ensure that enhanced narrative reporting will remain consistent with, and accepted by, overseas regulators, for example the US Securities and Exchange Commission.

79. When the proposed changes are made to the structure and format of reporting, the Government (through the Financial Reporting Council) will need to ensure that any accompanying guidance on the new provisions included clear minimum standards to ensure comparability. The Government must not shy away from strict enforcement of these standards. The scrutiny and consistency of narrative reports may be harder than that of reports containing only information about pounds and pence, but the Government must ensure high standards are maintained. We therefore recommend that the Government outlines how it proposes to implement auditing and monitoring of narrative reports. Ongoing shareholder scrutiny and transparency must be at the heart of this. These processes must be in place before the proposed changes come into effect.

5 More work to be done?

80. We now consider some of the less-specific ‘recommendations’ and underlying principles of the Kay Review. In particular, the Stewardship Code, resourcing stewardship, using a Financial Transaction Tax to incentivise behaviour and the role of owners in the process of mergers and acquisitions.

The Stewardship Code: Content

Box 1: The UK Stewardship Code

The UK Stewardship Code aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities. The Code sets out good practice on engagement with investee companies to which the Financial Reporting Council believes institutional investors should aspire and operates on a ‘comply or explain’ basis. The Financial Standards Authority requires UK authorised asset managers to report on whether or not they apply the Code.

First published in July 2010, the Code was revised in September 2012; the Financial Reporting Council encouraged all signatories to review their policy statements once the Code came in to effect from 1 October 2012.¹⁴²

81. In its current form, the Stewardship Code is voluntary. It embodies seven principles for institutional investors to:

1. Publicly disclose their policy on how they will discharge their stewardship responsibilities.
2. Have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed.
3. Monitor their investee companies.
4. Establish clear guidelines on when and how they will escalate their stewardship activities.
5. Be willing to act collectively with other investors where appropriate.
6. Have a clear policy on voting and disclosure of voting activity.
7. Report periodically on their stewardship and voting activities.¹⁴³

82. In his review, Professor Kay recommended that the Code be “developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of

¹⁴² Financial Reporting Council website, *UK Stewardship Code* [accessed 21 June 2013]

¹⁴³ Financial Reporting Council, *UK Stewardship Code*, September 2012, page 5

corporate governance”.¹⁴⁴ The Government noted the recommendation and highlighted the fact that the Financial Reporting Council (FRC) reviewed the implementation and impacts of its Codes, and would produce its next report on developments in Corporate Governance and Stewardship in December 2013.¹⁴⁵ The Government concluded that:

In light of this and future exercises it will consider whether further changes to the Stewardship Code may be desirable in due course to reflect Professor Kay’s recommendation.¹⁴⁶

83. The Chartered Institute of Personnel and Development did not believe that the Code required reform as it already focussed on corporate governance:

The revised UK Stewardship Code of September 2012 already includes strategy, corporate governance and culture within its definition of ‘stewardship activities’, on which institutional investors are encouraged to publicly disclose their activity with the aim of protecting value for their clients.

It is also recommended that investors should consider intervening when they have concerns about the company’s strategy, governance and approach to risks, including those that are social or environmental.¹⁴⁷

Steve Waygood, Chief Responsible Investment Officer at Aviva Investors, thought that the current Code, while fit for purpose, could be improved:

If I was rewriting the Stewardship Code, I would add a provision in there encouraging those people who sign up to the Stewardship Code to examine how they use their research commission to promote and finance stewardship.¹⁴⁸

84. FairPensions (now ShareAction) proposed four specific improvements that should be included in an improved Code:

- Articulate more explicitly that engagement can and should extend beyond immediate financial matters and encompass drivers of a company’s long-term fundamental value, including environmental, social and governance (ESG) factors.
- Address more explicitly the role of institutional investors, particularly ‘universal owners’ such as pension funds with holdings across the economy, in nurturing the wider economy and attending to potential systemic risks, rather than only engaging with risks to individual companies in their portfolio.

144 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 45, rec 1

145 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.5

146 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.5

147 Ev 138

148 Q 250

- Be stronger and clearer in respect of conflicts of interest. [...] The recent amendments to the Code [...] do not seek to ensure that signatories explain how key conflicts of interest are managed in practice.
- Articulate a clearer definition of ‘stewardship’. [...] The Code still does not define the term ‘stewardship’ as such. In our experience, there is still confusion over what is being ‘stewarded’ (companies, savers’ assets, or the economy and environment on which financial returns depend) and to whom stewardship obligations are owed (companies or savers).¹⁴⁹

Blackrock told us it defined the term ‘stewardship’ as “protecting and enhancing the value of the assets entrusted to us by our clients. As shareholders, our stewardship responsibility is to our clients”.¹⁵⁰ However, it warned us that good stewardship would not necessarily lead to more engagement with firms because asset managers must put their client first (rather than the long-term health of the companies that they hold):

Sometimes fulfilling our stewardship responsibilities to clients will involve engagement with companies; other times it will necessitate selling or reducing a shareholding if we cannot protect our clients’ interests through engagement, which should not be seen as a derogation of our duty, but a fulfilment of it.¹⁵¹

85. In its current form, the Stewardship Code contains seven voluntary principles which represent the minimum benchmark for the relationship between owners and investment managers. Professor Kay recommended that the Code should be developed to take account of strategic issues as well as those around corporate governance. We recommend that this be implemented through a formal consultation by the Financial Reporting Council. It is essential that the Code is accepted by all players of the equity market, therefore all such participants must have a say in its development. Having considered the evidence and suggestions from many players in the market, we specifically recommend that the Code be enhanced:

- ***To allow investment managers to focus on strategic issues facing companies within their policies on how they discharge their stewardship responsibilities (rather than the current focus on profit, which is inherently short-term).***
- ***To include the principle that engagement and corporate governance should extend beyond financial affairs and encompass more long-term value adding activities such as environmental, social and governance factors.***
- ***To include the provision that institutional investors and significant owners should be members of at least one Investor’s Forum.***

149 Ev 111–112

150 Ev 129

151 Ev 129

- *Related to the previous point, to include the role of institutional investors to engage in potential systemic risks to the UK equity market rather than only engaging with risks to individual companies in their portfolio.*
- *To redefine a clearer explanation of conflicts of interest and in particular for asset management firms to publish how key conflicts of interest are managed in practice.*
- *To provide one clear and authoritative definition of the term ‘stewardship’.*

The Stewardship Code: Sign-up

86. In its current form, 203 Asset Managers, 67 Asset Owners and 14 Service Providers have signed up to the Stewardship Code (although one organisation is listed as both an asset manager and a service provider).¹⁵² The Financial Reporting Council (FRC), which administers the Code, gave us the latest figures in terms of how much of the UK equity market is covered by the Code, referring to an IMA survey:

The IMA reported that the 103 respondents to this year’s survey included 73 managers who are responsible for £702 Billion of UK equities representing 36% of the UK market.¹⁵³

It went on to tell us, however, that because “not all signatories responded to the IMA survey”, it was “reasonable to say the overall total is slightly higher than the IMA’s figure”.¹⁵⁴

87. Although the rate of sign-up to the Code may have improved, the overall number of signatories remains low, particularly among owners (for example pension fund trustees). Penny Shepherd, Chief Executive of UKSIF hoped to see “considerably more asset owners signed up to the Stewardship Code”.¹⁵⁵ The National Association of Pension Funds Limited confirmed that its owners (and pension funds in general) had been slow to sign up. It suggested that investment consultants should have responsibility for encouraging more owners to be involved:

As key intermediaries between pension funds and asset managers, investment consultants could do more to encourage the take-up of the Code by explaining its relevance to their pension fund clients. We believe that this could help drive more pension funds to sign up to the Code.¹⁵⁶

Anita Skipper, Corporate Governance Advisor to Aviva Investors agreed. She told us that:

¹⁵² A full list of sign-up to the Stewardship Code may be found on: Financial Reporting Council website, *UK Stewardship Code statements* [accessed 21 June 2013]

¹⁵³ Ev 170

¹⁵⁴ Ev 170

¹⁵⁵ Q 307

¹⁵⁶ Ev 123

A lot of fund managers have already signed up. The disappointing bit is that the owners have not signed up. You want the owners to sign up so that the fund managers actually do the work for them. Fund managers do see the benefit of engagement, which is why [they] spend so much time engaging with companies, but it is very difficult to keep increasing that when nobody is asking you to do it and they do not even care. The focus must be on demand from our perspective.¹⁵⁷

88. When we aired these concerns with the Secretary of State he assured us that “if your hearings [...] elicit quite a lot of evidence that this approach is failing, I would feel obliged to respond to it”.¹⁵⁸ Our inquiry has raised concerns, and we look forward to his response.

89. Progress has been made in terms of the number of asset managers signing up to the Stewardship Code. However, sign-up among owners remains low. We recommend that the Government:

- ***Outlines what it considers a minimum acceptable level of sign up to the Stewardship Code (making provision for the distinction between manager and owner).***
- ***Makes clear that it is government policy to encourage sign-up to the Code and publishes a clear target (and timescale) of success. This timescale should be no longer than two years.***
- ***Outlines clearly what action it will take if this target is not met by the market on a voluntary basis.***

90. Finally, some witnesses pointed out that, at the time of our inquiry, the Parliamentary Contributory Pension Fund (PCPF) was not signed up to the Stewardship Code. Penny Shepherd, Chief Executive of UKSIF, told us that “one area in which this House can act to raise awareness is by acting as an exemplar of good practice”.¹⁵⁹ We are pleased to take this opportunity to formally welcome the fact that the trustees of this fund have made the decision to sign up to the Stewardship Code in the near future. We will continue to monitor this.

157 Q 252

158 Q 354

159 Q 280

The Stewardship Code and Professor Kay's good practice statements

91. As well as analysing the Stewardship Code, Professor Kay also produced three Good Practice Statements. These are outlined in full in the Annex to this report. His recommendation on the matter read:

Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements.¹⁶⁰

The Government responded:

The Government supports this recommendation. The development and promotion of good practice in the investment chain is central to achieving the culture shift that Professor Kay advocates. Professor Kay's suggested Good Practice Statements—aimed at company directors, asset managers and asset holders in turn—provide a starting point from which to achieve this.¹⁶¹

92. In his Review, Professor Kay outlined how he expected the Statements to sit alongside existing regulation:

We do not believe the principles set out in these statements should be translated into specific regulatory requirements. However, we do envisage that Regulators will also endorse these principles, consider to what extent existing regulatory requirements may prevent their adoption, and seek to align existing guidance and codes of practice with them.¹⁶²

He went on to explain that he expected his Good Practice Statements to “complement, and inform further development of the Corporate Governance Code and Stewardship Code”.¹⁶³ Although this approach could add to the regulatory burden, Professor Kay was clear that this was one area where he was happy for the Government to force the market's hand:

If the industries do not develop these kinds of concepts of good practice, I would like Government to intervene and try to do it for them.¹⁶⁴

93. Russell Investments supported Professor Kay's Statements because they were “developed explicitly for the growing and diverse ‘fiduciary management’ segment, which may, in the future, be in control of substantial portions of asset owners' portfolios”.¹⁶⁵ Dr Paul Woolley, Head of the Paul Woolley Centre for the Study of Capital Market

160 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 48, rec 2

161 Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.6

162 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 6.22

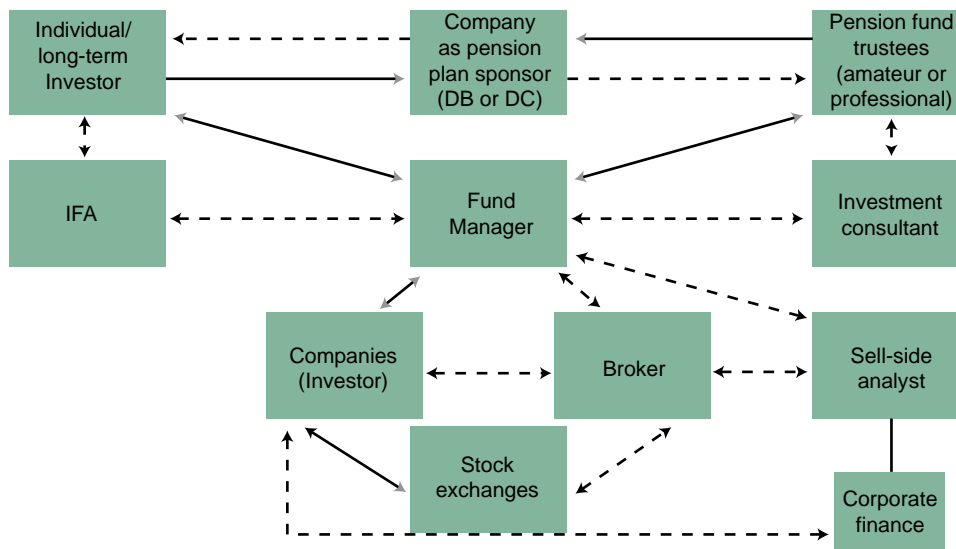
163 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 6.22

164 Q 23

165 Ev 92

Dysfunctionality, also supported the Statements and drew our attention to new recommendations of the Consultative Group on International Economic and Monetary Affairs Incorporated (G30) which recently made similar recommendations.¹⁶⁶ He believed that the industry was on the edge of change and that “there will be a very significant early mover advantage to funds” which adopted such statements first.¹⁶⁷

94. Aviva plc, however, was less supportive of Kay’s Statements. While it welcomed them in principle, it concluded that they “fail to cover all relevant players in the capital market”.¹⁶⁸ They provided the diagram below to demonstrate the complex series of impacts and interactions across the market and outlined which were and which were not covered by the Statements:¹⁶⁹



95. When we asked the Secretary of State how he saw Professor Kay’s Good Practice Statements running alongside existing regulation and voluntary codes, he acknowledged that there was a “mixture of voluntary stewardship codes of practice, on the one hand, and legislation on the other”.¹⁷⁰ However, he set out how Professor Kay’s analysis could be incorporated into the Stewardship Code:

We have just had a wholesale revision, which the FRC oversaw—you know the way the system works. Next year, we have asked them to go back to the stewardship code specifically to take into account the Kay recommendations.¹⁷¹

96. The Secretary of State concluded that reform was “a twin-track approach. There are key areas of corporate behaviour that have to be regulated, and are regulated, but for other

¹⁶⁶ Group of 30, *Long-term finance and Economic Growth*, February 2013

¹⁶⁷ Q 150

¹⁶⁸ Ev 102

¹⁶⁹ This is an updated version of the diagram found in Ev 102. Solid connections represent those which Aviva plc argue are covered by Professor Kay’s Good Practice Statements, dotted connections are those which it argues are not.

¹⁷⁰ Q 349

¹⁷¹ Q 349

areas, where subtle changes are involved, the voluntary approach works well, as it is the best solution and it works”.¹⁷²

97. We support Professor Kay’s Good Practice Statements and agree that the industry, asset holders and company directors should be given the opportunity to formally embrace the principles that are contained within them. However, we are conscious that many individuals and firms are already signed up to the Stewardship Code and we are concerned that yet another voluntary compliance statement will be submerged by a rising tide of self-regulation and codes of best practice. The market requires clarity and certainty and we are concerned about over-burdening it with regulation and codes.

98. Professor Kay’s Good Practice Statements should be the standard level of behaviour for the industry and all players in the UK equity market. We expect the Government, in its response to this Report, to outline its timetable for all companies to sign up to Professor Kay’s Good Practice Statements. If this target is not met, the Government should be prepared to incorporate Professor Kay’s Good Practice Statements into the already established Stewardship Code.

Resourcing stewardship

99. Lord Myners was clear in his mind that stewardship was an under-resourced activity in the investment chain:

There is an inverted pyramid in investment management, in which the least important functions receive the greatest attention and the highest pay, and the most important function receives little attention and, frequently, no pay.¹⁷³

Lord Myners set out where he saw the problem:

The decision on asset allocation for a pension fund—which is about understanding what your optimal level of risk is, creating a risk budget, and then saying that you will invest [...] is taken by trustees who are often unpaid; who are generally not professionals, or particularly economically knowledgeable; and who are led by the nose by consultants.

The most important decisions are taken by the people with least economic incentive and interest in the outcome, little reward, and little experience. On the other hand, the decision that adds no added value at all is hugely rewarded.¹⁷⁴

Harlan Zimmerman, Senior Partner at Cevian Capital, agreed that resourcing the roles of stewardship and governance was a problem across all types of funds. He told us that as a fund manager “you do the minimum that you can to protect your investments” because

172 Q 349

173 Q 117

174 Q 117

“there is a general issue that proper stewardship and engagement is a cost centre”.¹⁷⁵ He went on to explain that managers did the minimum that they needed to maintain appearances as a responsible investor:

You focus only on the greatest transgressions and react in a defensive way, and you do the minimum that society imposes upon you.¹⁷⁶

100. USS Investment Management Limited argued that it was a matter of scale and that stewardship was under-resourced in the relatively smaller UK pension funds when compared to larger funds globally. It told us that this was because funds were “too small to adequately resource their stewardship operations”.¹⁷⁷ It went on to explain that this had contributed to the lengthening of the investment chain and the subsequent distancing of the owner from the company.¹⁷⁸ Russell Investments told us that larger asset owners tended to have stronger governance because they:

- Have better access to expert resource and advice: taking together the number of finance or investment professionals on the trustee body or the investment committee, as well as any full-time in-house investment staff.
- Are more likely to have an investment committee.
- Spend more time in absolute terms on investment issues: trustee boards and their investment committees spend.
- Are more likely to have a more ambitious investment strategy.¹⁷⁹

It argued that consolidation was a practical solution to the problem of smaller funds not having the resources to effect good stewardship, pointing out that “current UK legislation makes it possible for smaller [pension] plans to join together, but there has been very little movement in that direction”.¹⁸⁰ Simon Wong agreed, noting that Canada already ran a similar system:

At present Canada has an interesting proposal, which is to mandate the transfer of assets from smaller pension funds to a new vehicle as a way to build scale. [...] You have a collective vehicle that hopefully will give you better scale and so reduce costs.¹⁸¹

101. Aviva plc also offered a solution to the cost of effective stewardship. It argued that, under the current regulation, equity commissions which are earned on all trades made by

175 Q 179

176 Q 179

177 Ev 167

178 Ev 167

179 Ev 96

180 Ev 97

181 Q 153

an asset manager may be used to “buy research from any type of provider and this global research spend amounts to \$22bn per year”.¹⁸² It explained:

A few fund managers—including Aviva Investors—are directing this research commission towards brokers and independent research providers of long-term investment research, voting advice and stewardship work. We are clear that such investment in stewardship adds value to investment decisions and is in the long-term interests of our clients.¹⁸³

102. However, this approach remains uncommon and that “those fund managers that do utilise this mechanism tend to spend only a few percentage points of their research commission in this way” because it was not actively encouraged by any official department or regulator.¹⁸⁴ When we asked how this could be encouraged in other firms. Aviva plc responded with four actions for the Financial Conduct Authority (FCA) to consider:

- The FCA could clarify that long-term investment research that is orientated towards good stewardship behaviour by investors can be paid for in this way.
- The FCA could suggest as a guide that it is good practice for a material proportion of the commission research (say 10-25%) to be spent in this way.
- The FCA could say that it is good practice for fund managers to be transparent to their clients that this was taking place.
- The FCA could say that it is good practice for clients to be allowed to opt out of this, as long as they are clear to their beneficial owners what their rationale is for so doing.¹⁸⁵

103. The Secretary of State was clear that he would like to see more resources allocated to stewardship.¹⁸⁶ We asked him about Aviva plc’s proposal and he appeared receptive, telling us that he agreed that better stewardship would “involve a certain amount of investment and the obvious way for the industry to invest would be to make a contribution from its own coffers”.¹⁸⁷

104. The attitude of ‘do the minimum possible’ found in many of our institutional investment firms has hindered the development of good stewardship. Asset managers are currently allowed to use commissions to pay for long-term research, including long-term stewardship, but it appears that few are aware of this. We therefore recommend that the Financial Conduct Authority contacts all major institutional investors highlighting that long-term investment research that is orientated towards good stewardship could (and should) be paid for using a proportion of equity commissions reserved for research.

182 Ev 107

183 Ev 107

184 Ev 107

185 Ev 107

186 Q 355

187 Q 356

Furthermore, we recommend that the FCA sets and publishes an appropriate minimum proportion of a firm's commission allocated to research that should be used towards such activities and an annual list of those firms which do not achieve that level. Those firms will be expected to comply or explain why they have not dedicated the recommended proportion of resources on good long-term stewardship.

The Financial Transaction Tax

105. High Frequency Trading (HFT) is often cited as an example how technological progress has been damaging rather than beneficial to the economy and there have been several attempts to analyse its impact on markets. The Bank of England reported that “HFTs contribute a large amount of both ‘good’ and ‘excessive’ volatility” and concluded that the “welfare implications of HFT are unclear”.¹⁸⁸ In 2011, the Government Office for Science produced a report which sought to answer the question: can high frequency trading lead to financial crashes? It concluded that “it has in the past, and it can be expected to do so more and more in the future”.¹⁸⁹ That Report concluded “the central question of the economic gains (and losses) provided by HFT” should be “considered seriously” and that the Government should:

Use regulations and tax incentives constitute the standard tools of policy makers at their disposal within an economic context to maximize global welfare (in contrast with private welfare of certain players who promote HFT for their private gains).¹⁹⁰

106. A recent report, commissioned by the Department for Business, Innovation and Skills and published by the Government Office for Science, concluded that:

The key message is mixed. The Project has found that some of the commonly held negative perceptions surrounding HFT are not supported by the available evidence and, indeed, that HFT may have modestly improved the functioning of markets in some respects.¹⁹¹

It concluded, however, that “policy makers are justified in being concerned about the possible effects of HFT on instability in financial markets” and recommended that:¹⁹²

European authorities, working together, and with financial practitioners and academics, should assess (using evidence-based analysis) and introduce mechanisms for managing and modifying the potential adverse side-effects of Computer based Trading (CBT) and HFT.¹⁹³

¹⁸⁸ Bank of England, *Working paper 469: High-frequency trading behaviour and its impact on market quality: evidence from the UK equity market*, December 2012, page 22

¹⁸⁹ Government Office for Science, *Crashes and high frequency trading*, August 2011, page 4

¹⁹⁰ Government Office for Science, *Crashes and high frequency trading*, August 2011, page 4

¹⁹¹ Government Office for Science, *The future of computer trading in Financial markets*, October 2012, page 5

¹⁹² Government Office for Science, *The future of computer trading in Financial markets*, October 2012, page 5

¹⁹³ Government Office for Science, *The future of computer trading in Financial markets*, October 2012, page 14

And:

Coordination of regulatory measures between markets is important and needs to take place at two levels:

- Regulatory constraints [involving computer based trading] in particular need to be introduced in a coordinated manner across all markets where there are strong linkages.
- Regulatory measures for market control must also be undertaken in a systematic global fashion to achieve in full the objectives they are directed at.¹⁹⁴

107. We asked Professor Kay whether the Government should introduce a tax on this activity, not to raise revenue, but to influence behaviour. He was clear that:

If we could have a financial transactions tax that worked, it would seem to me to be a very attractive way of discouraging that trading activity in favour of long-term investment.¹⁹⁵

108. However, he went on to explain that it was “very difficult to structure a financial transactions tax that works”.¹⁹⁶ When we spoke to Chris Hitchen, who was a member of Professor Kay’s Advisory Board Team, he told us that this was an area where the team “feared to tread” and had anyway not had time to investigate fully:

Around the table we were reasonably well disposed towards a financial transaction tax, which might help to mitigate that. We did not pursue that, but it is something we definitely picked up.¹⁹⁷

He described the structural problems that Professor Kay had referred to as stemming from the global nature of transactions, summarising that “there are problems with imposing any sort of tax on a partial basis in a global market”.¹⁹⁸ He emphasised that, from his perspective as the Chief Executive of RailPen, he supported a Financial Transaction Tax:

It could potentially take a lot of unnecessary trading out of the system. Who pays for the profits of traders? Ultimately it seems to me it is the end investors; it is my members. Even if we end up paying a small tax on the trades that we do, if it stops us paying for a lot of profits on other peoples’ activities, then we are still better off, net-net.¹⁹⁹

194 Government Office for Science, *The future of computer trading in Financial markets*, October 2012, page 14

195 Q 74

196 Q 74

197 Q 269

198 Q 271

199 Q 272

109. Lord Myners told us that, from his experience of more than a decade analysing the market that he was “drawn towards a financial transaction tax: ideally, one that is established globally”.²⁰⁰ He suggested a solution to the ‘global problem’ that hindered progress during the Kay Review:

We should not allow any bank in a developed country to establish a branch or a subsidiary in an offshore centre that does not comply with the OECD’s white list of financially compliant economies. You could do something similar in terms of transactions.²⁰¹

110. While some representatives from industry agreed that an FTT could be beneficial to the market, they did so with heavy caveats. For example, Steve Waygood from Aviva Investors told us that “we only agree that the financial transaction tax is a good idea if it could be done simultaneously in all key financial jurisdictions”.²⁰² However, he was not confident that this was possible:

Unfortunately the political practicalities of that mean that it might be an academically good idea for Tobin 30 years ago, but the current manifestation of it is not something that we would support.²⁰³

111. Anne Richards, Global Chief Investment Officer of Aberdeen Asset Management told us that HFT should be more closely monitored and linked to the tax system:

There is another subset of market behaviours that have become technologically possible in a way that they were not before and I do not necessarily think that the market processes around the control of that or the taxation rules have kept up with the changes that technology has allowed.²⁰⁴

She conceded that a more consistent tax regime across the wide range of financial instruments (including HFT) could “get around some of these behaviours”, but reached the conclusion that it was “a difficult area to see how you would implement a financial transactions tax in a really beneficial way to the end customer”.²⁰⁵

112. Dominic Rossi, Global Chief Investment Officer at Fidelity Worldwide, did not believe that a FTT would work if its objective was to change behaviour. However, he did say that it would be successful at raising money.²⁰⁶ This ran in direct conflict with the evidence put forward by the Secretary of State:

200 Q 103

201 Q 103

202 Q 273

203 Q 273

204 Q 204

205 Q 207

206 Q 207

Countries like Hungary, France and elsewhere were getting in a fifth or a quarter of the revenue that they thought they would get, because it is so very, very difficult to pin down these transactions and tax them in a sensible way.²⁰⁷

However, when we asked the Secretary of State if he was willing to consider the introduction of an FTT to clamp down on poor practices (for example HFT) rather than simply making money for the exchequer, he was clear:

Yes, I think there is a case, and I am, in some ways, quite disposed to it.²⁰⁸

He also agreed with Professor Kay that “the problem, all along, has been implementing” and drew our attention to the difficulty of identifying which transactions to tax when there were “very rapid electronic transactions” and “cross-border transactions” which were difficult to trace.²⁰⁹

113. There was some support for the concept of a Financial Transaction Tax on trading practices such as High Frequency Trading. However, concerns were raised about the practicality of implementing such a tax unilaterally. We recommend that the Government considers the viability, benefits and risks of a Financial Transaction Tax and commissions research in the following areas:

- i. An impact assessment of the introduction of a Financial Transaction Tax on equities at a level which is the average profit made on a High Frequency Trade in the UK.*
- ii. A impact and feasibility study of the proposal to ban any of those banks which establish branches or subsidiaries in an offshore centre that does not adhere to the OECD’s white list of financially compliant economies from trading in the UK. This should include an assessment of whether doing so would counter the arguments against a domestic FTT being ineffective in the global market.*

Mergers and acquisitions

114. In his report, Professor Kay also considered the impact of mergers and acquisitions. He concluded that

The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves.²¹⁰

The Secretary of State told us that he agreed with the Review’s recommendation:

207 Q 358

208 Q 358

209 Q 358

210 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 62, rec 4

There is a lot of research that tends to show that, probably on balance, it reduces shareholder value, quite apart from any social consequences. However, there is counter-evidence.²¹¹

He concluded that he was “sceptical about the value of takeover activity” but did not want to outlaw it altogether because “if companies are underperforming and their shareholders are being poorly awarded for bad performance, there has to be a mechanism in the market to correct that”.²¹²

115. Professor Kay, however, did draw a distinction:

The openness of the UK acquisition market means that UK companies are a favoured target of global investment banks which seek to promote transactions activity.²¹³

116. He concluded that “UK companies are disproportionately vulnerable to unwanted attention from predators.”²¹⁴ Lord Myners agreed, arguing that the UK regime governing takeovers was very relaxed relative to other countries:

Our rules seem to be extraordinarily permissive, and one might sit back for a moment and ask whether it is actually in the benefit of the economy and society, and why we have concluded that we want to make it so much easier to take over companies than elsewhere.²¹⁵

117. While Lord Myners agreed with Professor Kay’s analysis, he thought that the recommendation could go further. He told us “there is nothing in the Professor’s report that seriously challenges the value and job destruction associated with reckless merger and acquisition activity”.²¹⁶ Lord Myners urged the Government to be wary of all takeover activity, not just that involving foreign companies because “as much damage is done by M&A of British acquirers of British companies as is done by foreign acquirers of British companies”.²¹⁷

118. In his recent report, *No stone unturned in pursuit of growth*, Lord Heseltine recommended that the “Government should do far more to engage with potential foreign investors in our core sectors to secure commitments to developing the UK research, skills and supply base, and in exceptional cases to discourage unwanted investments”.²¹⁸ The Government rejected this:

211 Q 363

212 Q 363

213 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 8.13

214 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 8.13

215 Q 109

216 Q 83

217 Q 109

218 Lord Heseltine, *No stone unturned in pursuit of growth*, October 2012, page 154, rec 73

As a Government, we have rejected the Heseltine recommendation on foreign takeovers. We should not be distinguishing between domestic and foreign ownership. It is not helpful, and some of our best companies are owned by “foreigners”.²¹⁹

119. Professor Kay recommended that the Government should take a more ‘sceptical’ view of the benefits of large takeovers and should be much more proactive in its monitoring of such activity. He drew particular attention to the relative vulnerability of UK companies to takeovers by foreign actors. We recommend that the Government conducts and publishes an assessment of the take-over regimes of other similar economies with a view to learning about the impact that takeovers have had on their companies and economies. Furthermore it should summarise which positive elements may be incorporated into our domestic system to strengthen our economy and ensure that takeovers benefit, rather than damage our economy.

120. The Government has accepted Professor Kay’s recommendation on mergers and acquisitions but it is unclear what specific action it will take. We recommend that the Government clarifies what actions it will take over the next six months to be in a position to effectively monitor all merger activity in the UK. In its response to us, the Government should outline what action it will take to engage with companies and their investors to ensure that any investment merger activity is to the long-term benefit of the UK economy.

Box 2: A case study of The Cadbury / Kraft takeover as reported in the Financial Times.

An illustration of how short-term shareholders have influenced the UK equity market and the fate of a successful British company:

The story

In 2009, US food company Kraft Foods launched a hostile bid for Cadbury, the UK-listed chocolate maker. As became clear almost exactly two years later in August 2011, Cadbury was the final acquisition necessary to allow Kraft to be restructured and indeed split into two companies by the end of 2012: a grocery business worth approximately \$16bn; and a \$32bn global snacks business. Kraft needed Cadbury to provide scale for the snacks business, especially in emerging markets such as India. The challenge for Kraft was how to buy Cadbury when it was not for sale.

The history

Kraft itself was the product of acquisitions that started in 1916 with the purchase of a Canadian cheese company. By the time of the offer for Cadbury, it was the world's second-largest food conglomerate, with seven brands that each generated annual revenues of more than \$1bn.

Cadbury, founded by John Cadbury in 1824 in Birmingham, England, had also grown through mergers and demergers. It too had recently embarked on a strategy that was just beginning to show results. Ownership of the company was 49 per cent from the US, despite its UK listing and headquarters. Only 5 per cent of its shares were owned by short-term traders at the time of the Kraft bid.

The challenge

Not only was Cadbury not for sale, but it actively resisted the Kraft takeover.

Sir Roger Carr, the chairman of Cadbury, was experienced in takeover defences and immediately put together a strong defensive advisory team. Its first act was to brand the 745 pence-per-share offer “unattractive”, saying that it “fundamentally undervalued the company”. The team made clear that even if the company had to succumb to an unwanted takeover, almost any other confectionery company (Nestlé, Ferrero and Hershey were all mentioned) would be preferred as the buyer. In addition, Lord Mandelson, then the UK's business secretary, publicly declared that the government would oppose any buyer who failed to “respect” the historic confectioner.

The response

Cadbury's own defence documents stated that shareholders should reject Kraft's offer because the chocolate company would be “absorbed into Kraft's low growth conglomerate business model—an unappealing prospect that sharply contrasts with the Cadbury strategy of a pure play confectionery company”.

Little did Cadbury's management know that Kraft's plan was to split in two to eliminate

its conglomerate nature and become two more focused businesses, thereby creating more value for its shareholders.

The result

The Cadbury team determined that a majority of shareholders would sell at a price of roughly 830 pence a share. A deal was struck between the two chairmen on January 18 2010 at 840 pence per share plus a special 10 pence per share dividend. This was approved by 72 per cent of Cadbury shareholders two weeks later.

The key lessons

As this deal demonstrates, these shareholders may not (and often will not) be the long-term traditional owners of the target company stock, but rather very rational hedge funds and other arbitrageurs (in Cadbury's case, owning 31 per cent of the shares at the end), who are swayed only by the offer price and how quickly the deal can be completed. Other stakeholders may have legitimate concerns that need to be addressed but this can usually be done after the deal is completed, as Kraft did.²²⁰

121. We followed closely the Cadbury / Kraft takeover and published two Reports on the matter.²²¹ At the beginning of that takeover, only five percent of owners were considered 'short-term'. By the time the takeover went through this figure was more than 31 per cent.²²²

122. Professor Kay analysed the problem of short-term investors essentially forcing takeovers of companies against the wishes of longer-term shareholders. He considered solving this problem through 'differential voting rights' on shares:

One suggestion was that voting rights should accrue only after being on the share register for a specified period. This might be a general rule or one specifically applicable during takeover.²²³

However, he concluded that this was not practicable because "the introduction of such provisions by legislation or regulation would involve practical difficulties and would be unlikely to achieve the intended effect".²²⁴ He also believed that regulation would be unnecessary should his recommendations on good stewardship bear fruit.²²⁵

123. Many expert witnesses agreed with this perspective. Anita Skipper, Corporate Governance Advisor for Aviva Investors, told us that the "one share, one vote principle is

220 Financial Times, *Case study: Kraft's takeover of Cadbury*, 9 January 2012 [extracts]

221 Business, Innovation and Skills Committee, Ninth Report of Session 2009–10, *Mergers, acquisitions and takeovers: the takeover of Cadbury by Kraft* and Business, Innovation and Skills Committee, Sixth Report of Session 2010–12, *Is Kraft working for Cadbury?*

222 Financial Times, *Case study: Kraft's takeover of Cadbury*, 9 January 2012

223 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 8.32

224 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 8.32

225 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 8.32

the fairest principle”.²²⁶ She argued that introducing differential voting rights would introduce new problems:

There are too many problems once you start giving out differential voting rights, and things that are not actually supportive of what we are trying to do here. You could entrench management whom you are trying to persuade to change what they are doing.²²⁷

Neil Woodford agreed, and argued that in this case the market had worked efficiently:

The long-term shareholders who owned Cadbury decided that the price that was being offered was attractive enough for them to sell their shares, because there is always, of course, an opportunity cost associated with investment. You can take your capital from your particular investment and deploy it more productively elsewhere.²²⁸

124. We asked the Secretary of State if he had considered whether to give preference to long-term investors over short-term investors. He told us that his “instincts are to go back to it”.²²⁹ However, he identified three specific obstacles to differentiating voting rights during the takeover of a company:

- If you stop the short-term investors, you reduce the demand for shares, you drive down the share price and you then make the takeover more attractive.
- If you stop long-term investors from acquiring shares in order to build up their stake in the company during the takeover period.
- We do not have an effective system, at the moment, for distinguishing between nominees and original owners. In the UK, we do not have that, so it is not possible to divide the share register in the way that one would ideally like.²³⁰

He closed his evidence asking us to “help me by finding a way past them”.²³¹

125. We have heard evidence that the ‘one-share one-vote’ is fairest. Some witnesses pointed out to us that the long-term shareholders must choose to sell to short-term traders and argued that the ‘market’ ruled. However we cannot help but think back to the evidence that we have heard that, overall, takeovers detract value from companies. The Secretary of State told us that his instinct was to go back and consider introducing

226 Q 256

227 Q 256

228 Q 260

229 Q 330

230 Q 330

231 Q 330

differential votes (i.e. encouraging the principle that short-term traders should have no influence over the takeover vote).

126. We recommend that the Department produces a feasibility study which clearly outlines the risks and benefits of introducing a policy that differentiates between shareholders and voting rights based on the length of time a share has been held.

127. We further recommend that the Government commissions a study to set out the impact on the UK of foreign takeovers of British companies over the past 25 years.

6 Measuring success

Moving forward

128. At the beginning of this Report we challenged the Government to ensure progress in the implementation of Professor Kay’s recommendations. The Government set out its intentions in its written evidence to us:

The Government response commits the Government to publish an update, in summer 2014, setting out what further progress has been achieved by government and others, to consider Professor Kay’s directions for regulatory policy and to deliver his specific recommendations.²³²

129. Lord Myners was in a similar position to Professor Kay ten years ago. His Review received similar support and promise of follow-up from the Government at the time but many of his recommendations were not implemented. Lord Myners told us that he had been “very disappointed” by that lack of progress.²³³ He believed that the Kay Review “relied on the same statements on principles of best practice” that he had relied on, and that little would happen unless there was a “forcing mechanism”.²³⁴ In particular he argued that the Government needed to “get much more involved and engaged”.²³⁵

130. Dominic Rossi, Global Chief Investment Officer at Fidelity Worldwide, hoped that the Review would be built on and suggested that the Government and the industry should both be held to account for progress in three specific areas:

- Stewardship. Too many asset managers, as I have said already, view their responsibility solely to be that of investment performance rather than also improving the performance of the companies in which they invest.
- Short-termism. By asset managers getting closer to the end client and strengthening our direct relationships with the end client we will improve persistency of assets, and that will have a spin-off in terms of the investment time period.
- Remuneration. Corporate remuneration is too complex and too short-term.²³⁶

131. Although the National Association of Pension Funds Limited believed that “by endorsing Professor Kay’s recommendations the Government is giving a clear direction of

232 Ev 86

233 Q 84

234 Q 129

235 Q 129

236 Q 174

travel”,²³⁷ others were more sceptical. For example the UK Shareholders Association told us that:

Very little is likely to be achieved without a strong push from Government. Moreover any review dependent on ‘market participants’ will surely be biased towards the interests of the financial services industry, which largely conducts its affairs with other people’s money; those whose money it usually is, namely private investors and savers, are usually absent from such reviews and so need the Government to act on their behalf.²³⁸

It went on to recommend that:

A positive way forward would have been for the Secretary of State to call industry leaders together to bring their influence to bear in establishing these principles and threatening them with legislation if they failed to do so. [...] There is no indication in the Response of any one individual or Department having been given any power or responsibility to drive this forward.²³⁹

132. The Association of General Counsel and Company Secretaries of the FTSE 100 appeared to agree, but urged the Government to remember that “in addition to the domestic framework, the UK equity markets are subject to regulation at the European and international level” and that:

Although we believe that many of the recommendations in the Kay Review and the Government’s response are commendable, it is imperative that any specific proposals flowing from the Kay Review be formulated and implemented in this context.²⁴⁰

133. We asked the Secretary of State how he saw the market evolving after the Kay Review, and whether he would seek any power to influence the industry if it did not change voluntarily. He replied that “there is no obvious big stick to wave”,²⁴¹ but went on to explain that he wanted to “encourage” change rather than compel it:

I would strongly encourage them to participate in that and make sure it works. I would also strongly encourage them to listen to the statements of best practice that have emerged from the representative bodies in the industry, because that is how standards are raised.²⁴²

He went on to outline the minimum progress that he expected to make by the summer of 2014 (two years after the publication of the Kay Review):

237 Ev 122

238 Ev 134

239 Ev 134

240 Ev 115

241 Q 319

242 Q 318

I would have thought that the minimum is:

- That the investors' forum, which is at the heart of Kay's recommendations, would be up and running and functioning, and we would be able to see a discernible impact.
- That the various statements of good conduct that have been issued by the trade bodies will be in place and will have been visibly acted upon.
- That, at roughly the same time, we would have a clear conclusion from the Law Commission.²⁴³

134. Lord Myners' Review was published more than a decade ago and yet we find ourselves examining the same issues and principles in the Kay Review today. Professor Kay's findings and proposals must not be 'kicked into the long grass' by the Government or the industry. Professor Kay's specific recommendations need to be acted on and we will hold those responsible to account. Where Professor Kay has provided overarching principles these need to be turned into actions. The Secretary of State has assured us that there is an appetite for change in the Government and we have heard that this is mirrored in the industry. Therefore, there can be no excuse for inaction by either the Government or the industry.

135. We recommend that the Government immediately publishes clear, measurable and achievable targets for implementation of the Kay Review. In particular, in its response to this Report, the Government must outline for each of Professor Kay's 17 recommendations what needs to have been achieved by the Government's review of progress in 2014.

Regulatory or voluntary approach?

136. A recurrent theme in this inquiry was how to get the right balance between regulation and voluntary change in implementing Professor Kay's recommendations and principles. In his Review, Professor Kay was clear that he favoured giving the industry an opportunity to change without calling for legislation:

We have tried to avoid prescriptive regulation wherever possible in framing these recommendations. We believe the lesson of recent financial crises is that the cultural changes we seek can be achieved only by changing the structure of the industry and the incentives of those who work in it, not by ever more prescriptive rule books of behaviour.²⁴⁴

Professor Kay based this view on his belief that regulation could create perverse incentives for players in the equity market and had been a cause for lengthening the chain of investment. He stated that "the existing structure of the investment chain is the product of

243 Q 377

244 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 13.16

a highly regulated environment” and that this had spiralled out of control because additional layers of oversight had been required:²⁴⁵

If we want to establish trust relationships as the basis of financial services—and I believe we do—we cannot regulate trust relationships very easily. We need to set up structures and environments in which people can develop them and in which they are encouraged to develop them, rather than the one we have at the moment in which people are going through large amounts of compliance based form filling and box ticking.²⁴⁶

137. Professor Kay summarised that while he did “not seek either more or less regulation” he expected the “long-run outcome” of his approach to be “less regulation”.²⁴⁷ He told us that there were two main disadvantages to legislating for change compared to encouraging it on a voluntary basis:

One is that they are inflexible—not all of these regulations will be applicable to all situations and all companies.

The other is that people will be inclined to believe that, so long as they have complied in a formal sense, then they have done their job.²⁴⁸

The Government agreed:

The Government response makes clear that the necessary changes in culture cannot simply be achieved through regulation, but rather through the development of good practice in the investment chain. The Government is therefore promoting Professor Kay’s Good Practice Statements for company directors, asset managers and asset holders, as the starting point for industry-led standards of good practice.²⁴⁹

138. Perhaps unsurprisingly, many of the industry practitioners agreed with Professor Kay and told us that they were concerned about burdening the sector with regulation. For example Neil Woodford, Head of UK Equities in Invesco Perpetual, told us that he was “instinctively concerned about too much regulation”.²⁵⁰ He went on to say that regulation “in and of itself alone” would not deliver the desired outcomes because what was needed was a “whole structural change in terms of incentive structures in the industry”.²⁵¹ The Chartered Institute of Personnel and Development agreed:

245 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 5.36

246 Q 17

247 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 12.4

248 Q 21

249 Ev 85

250 Q 253

251 Q 253

Changing an organisation’s culture fundamentally requires changes in leadership behaviours and cannot happen overnight, but it begins at the top and is reinforced through performance measures and reward practices.²⁵²

139. Daniel Godfrey, the Chief Executive of the Investment Management Association warned that firms could hide behind compliance with regulation without actually changing their culture:

We can put in place things that make it look like things are happening really easily through regulation, but real progress will come from belief—people believing it will work—and also pressure from the demand side because they believe it will work, and that is entirely achievable over a period of time.²⁵³

140. Albion Ventures LLP argued that “changes should be cultural rather than legislative” and asserted that it was essential that investors were “not deterred by excessive regulatory red tape or other investment barriers”.²⁵⁴ Matthew Fell, the Director of Competitive Markets for the CBI, stated that better engagement could not be forced by any Government:

On the balance between regulation and advocacy, if the task in hand is really to drive up high-quality engagement, I struggle to see how you actually generate those sorts of conversations through regulation.²⁵⁵

141. On the other hand, several witnesses told us that the industry had had long enough to enact change for itself and that the Government should now be firmer in its approach. For example, the UK Shareholders Association told us that it was “essential that the Government legislates to remove the obstacles to what should be investors’ right to be treated as full shareholders”.²⁵⁶ FairPensions (now ShareAction) took this point further and suggested specific areas where formal change (be it regulation or legislation) was needed:

- Pension funds should be obliged to report to their beneficiaries not just on their investment and voting policies (as now), but also on how those policies have been implemented on an annual basis.
- Government should exercise its reserve power to introduce mandatory voting disclosure for institutional investors.
- Institutional investors could be obliged to hold annual meetings (in the same way that companies must hold annual meetings for their shareholders) offering savers the opportunity to hold their fiduciaries to account.

252 Ev 137

253 Q 310

254 Ev 91

255 Q 310

256 Ev 135

- Government could explore ways to support and strengthen the role of member-nominated trustees, and to extend similar member representation to contract-based forms of pension provision.²⁵⁷

Lord Myners added to this list, telling us that the “Government should force the creation of this investor forum, and it should say that the financial means will be placed there for it”.²⁵⁸

142. The Government was clear in its support of Professor Kay’s ‘voluntary first—legislate later’ approach. When we spoke to the Secretary of State, however, he told us that there was a balance to be found and that regulation could be introduced alongside cultural changes. He clarified the areas that he was prepared to legislate in and those he would leave to the industry:

There is a two-track approach to most of these questions. In the mandatory area, of course, we have the legislation on executive pay, and narrative reporting is coming into effect as well.²⁵⁹

He went on to tell us that:

There are key areas of corporate behaviour that have to be regulated, and are regulated, but for other areas, where subtle changes are involved, the voluntary approach works well, as it is the best solution and it works.²⁶⁰

The Secretary of State was slightly more firm however, on the consequences for the industry if it did not change:

I do not have any problem with adopting tough regulatory solutions when voluntary methods have failed and we have demonstrated that in one or two areas, with executive pay being the most obvious one. [...] My approach to all these things [...] is to try the voluntary approach and try to build up trust with the practitioners. If it fails, we can adopt more aggressive solutions, but let us try the voluntary approach first.²⁶¹

143. In considering the merits of a voluntary approach versus a statutory one, it is worth returning to the Myners Review of 2001:

The review therefore believes it is important at least to attempt to seek an effective approach which does not rely on direct Government intervention in banning or directly determining behaviour.²⁶²

In 2012, Professor Kay wrote:

257 Ev 114

258 Q 92

259 Q 349

260 Q 349

261 Q 383

262 Lord Myners, *Myners Review of institutional investment: Final Report*, March 2001, page 2

The Review believes that it is generally more effective, and in the long-term less intrusive, to give incentives to do the right thing than to attempt to prevent people who are subject to inappropriate incentives from doing the wrong thing.²⁶³

144. We sympathise with Professor Kay and the Secretary of State’s concerns that over prescription and formal legislation risk alienating the UK equity market in a global environment, providing false security through ‘tick-boxing’ and distorting the effective operation of the market. However, we have yet to be convinced that all of the major players in the institutional investment sector are committed to significant voluntary reform.

145. We agree that the industry should be given a chance to change of its own volition but the experience of the Myners Review does not fill us with confidence. A cultural change will not happen without a catalyst. Ministers must be willing, and seen to be willing, to pick up a ‘regulatory stick’ should progress stall. We reiterate our recommendations that the Government has to set out a timetable for reform which includes the following for every one of Professor Kay’s recommendations:

- *a clear measure of success for the recommendation (the target);*
- *who is responsible for achieving the target;*
- *a clear deadline by which the target needs to be achieved; and*
- *the action that the Government will take if the target is not achieved.*

263 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, para 6.17

Conclusions and recommendations

In the report conclusions are shown in **bold**, recommendations are shown in ***bold italics***. In this list, recommendations are shown in *italics*.

Previous review of the market

1. In the 12 years since the Myners Review, little has changed in the role and actions of institutional shareholders. The recommendations and findings of the Kay Review cannot be ignored or diluted as we have heard the Myners Review was. The similarities between the remit of the Kay review and that of the Myners Review demonstrate that little progress has been made to reform the sector. It is therefore critical that they do not share a similar fate. The Government must play an active role to drive reform on implementation of Professor Kay's recommendations. Our Report, therefore, concentrates on where that activity must take place. (Paragraph 14)

Investors Forum

2. *We agree with Professor Kay and the Government that collective engagement is to the benefit of the equity market and UK businesses. However, we are concerned that the hands-off approach taken by the Government runs the risk that progress will stall. The Government has provided no remit, deadline or resource for the Investor's Forum and the 'working group' to investigate the concept of the Investor's Forum will not report until later in 2013. The Government has told us that it will publish an update on progress in the summer of 2014. We recommend that the Government outlines a clear timetable for setting up the Forum before that point, engaging with different types of investors, along with milestones and assigned responsibilities for achieving this.* (Paragraph 27)

Fiduciary duty

3. *The Law Commission is currently consulting on the legal definition of fiduciary duty and will not report back until June 2014. We believe that this is too slow. We recommend that the Government liaises with the Law Commission to bring forward the timing of this project. The Government is paying up to £140,000 for this project and we expect it to push for the highest value for the taxpayer's money. The Law Commission will launch a three month consultation in October 2013. We suggest that it gives this issue the appropriate priority and publishes its final definition in the first quarter of 2014.* (Paragraph 36)

Appointment of executives

4. *Professor Kay has provided a clear recommendation, proposing that companies consult with major investors over all board appointments and the Government has agreed to implement this. We therefore recommend that the Government publishes a timetable for the implementation of this policy, clarifies which investors companies are to consult*

with and outlines how it intends to combat the issues surrounding insider trading and confidentiality which inevitably accompany such board appointments. Alongside this, the Government should undertake an impact assessment, particularly looking at the possible increase of bureaucratic burdens on small businesses and, if necessary, introduce an opt-out clause for them. (Paragraph 43)

Remuneration of executives

5. The Government has accepted the principles underlying Professor Kay's recommendation on the remuneration of executives. We are therefore disappointed that it has failed to take the action to see it put into practice or responsibility for its implementation. We are not persuaded by the Government's view that businesses will see the benefit of this recommendation and will adopt this measure voluntarily. (Paragraph 52)
6. *We support the recommendation that company directors should be tied into the long-term performance of their companies through time-appropriate shares. Since the Government has accepted Professor Kay's analysis and agreed with his findings, it should reconsider its response and take an active approach to its implementation. In particular, we recommend that the Government outlines how it intends to combat the issue of directors using options and derivatives to avoid these rules. Alongside this the Government should outline how it will ensure that departing directors will not be perversely incentivised to artificially inflate the share price immediately prior to their retirement or retire early to realise the locked-in value of their shares. (Paragraph 53)*

Incentivising fund managers

7. The incentives driving the actions of fund managers are one of the most important factors within the investment chain. Professor Kay made a specific recommendation on this but the Government has shied away from accepting it, citing an unwillingness to prescribe pay structures. While this may be understandable, it is clear that the Government must be involved; at the very least encouraging a cultural shift away from short-term to long-term performance-based pay. (Paragraph 62)
8. *We recommend that the Government takes a harder line when framing the culture in which fund managers work by highlighting best practice where it sees it. We further recommend that it should work towards the goal that fund manager performance be reviewed over longer time horizons than the typical quarterly cycle. (Paragraph 63)*
9. *One way that the Government can help effect a culture change in the incentives driving fund-manager behaviour is to develop and publish a set of long-term measures of success alongside options for sanctions for demonstrable failure. We recommend that it does so, and then annually publishes a list of those firms that have fully adopted such measures. This would provide a different measure of success to the very short-term ones which are currently available. (Paragraph 64)*

Quarterly reporting

10. *We support Professor Kay's recommendation that the requirement for quarterly reporting should be removed and recommend that the Government now outlines a clear timetable to implement this recommendation including what alternative strategies would be followed in the absence of any change in EU law. (Paragraph 70)*
11. *We recommend that the Government sets out details of progress in negotiations with other international accounting standard bodies (such as the U.S. Securities and Exchange Commission) on the requirement for quarterly reporting to ensure that any changes made to the domestic or EU-wide accounting practices are accepted on a global level. (Paragraph 71)*

Narrative Reporting

12. *We recommend that the Government sets out how it will ensure that enhanced narrative reporting will remain consistent with, and accepted by, overseas regulators, for example the US Securities and Exchange Commission. (Paragraph 78)*
13. *When the proposed changes are made to the structure and format of reporting, the Government (through the Financial Reporting Council) will need to ensure that any accompanying guidance on the new provisions included clear minimum standards to ensure comparability. The Government must not shy away from strict enforcement of these standards. The scrutiny and consistency of narrative reports may be harder than that of reports containing only information about pounds and pence, but the Government must ensure high standards are maintained. We therefore recommend that the Government outlines how it proposes to implement auditing and monitoring of narrative reports. Ongoing shareholder scrutiny and transparency must be at the heart of this. These processes must be in place before the proposed changes come into effect. (Paragraph 79)*

The Stewardship Code: Content

14. *In its current form, the Stewardship Code contains seven voluntary principles which represent the minimum benchmark for the relationship between owners and investment managers. Professor Kay recommended that the Code should be developed to take account of strategic issues as well as those around corporate governance. We recommend that this be implemented through a formal consultation by the Financial Reporting Council. It is essential that the Code is accepted by all players of the equity market, therefore all such participants must have a say in its development. Having considered the evidence and suggestions from many players in the market, we specifically recommend that the Code be enhanced:*
 - *To allow investment managers to focus on strategic issues facing companies within their policies on how they discharge their stewardship responsibilities (rather than the current focus on profit, which is inherently short-term).*

- *To include the principle that engagement and corporate governance should extend beyond financial affairs and encompass more long-term value adding activities such as environmental, social and governance factors.*
- *To include the provision that institutional investors and significant owners should be members of at least one Investor’s Forum.*
- *Related to the previous point, to include the role of institutional investors to engage in potential systemic risks to the UK equity market rather than only engaging with risks to individual companies in their portfolio.*
- *To redefine a clearer explanation of conflicts of interest and in particular for asset management firms to publish how key conflicts of interest are managed in practice.*
- *To provide one clear and authoritative definition of the term ‘stewardship’.* (Paragraph 85)

The Stewardship Code: Sign-up

15. *Progress has been made in terms of the number of asset managers signing up to the Stewardship Code. However, sign-up among owners remains low. We recommend that the Government:*

- *Outlines what it considers a minimum acceptable level of sign up to the Stewardship Code (making provision for the distinction between manager and owner).*
- *Makes clear that it is government policy to encourage sign-up to the Code and publishes a clear target (and timescale) of success. This timescale should be no longer than two years.*
- *Outlines clearly what action it will take if this target is not met by the market on a voluntary basis.* (Paragraph 89)

16. Finally, some witnesses pointed out that, at the time of our inquiry, the Parliamentary Contributory Pension Fund (PCPF) was not signed up to the Stewardship Code. Penny Shepherd, Chief Executive of UKSIF, told us that “one area in which this House can act to raise awareness is by acting as an exemplar of good practice”. We are pleased to take this opportunity to formally welcome the fact that the trustees of this fund have made the decision to sign up to the Stewardship Code in the near future. We will continue to monitor this. (Paragraph 90)

The Stewardship Code and Professor Kay’s good practice statements

17. We support Professor Kay’s Good Practice Statements and agree that the industry, asset holders and company directors should be given the opportunity to formally embrace the principles that are contained within them. However, we are conscious that many individuals and firms are already signed up to the Stewardship Code and we are concerned that yet another voluntary compliance statement will be

submerged by a rising tide of self-regulation and codes of best practice. The market requires clarity and certainty and we are concerned about over-burdening it with regulation and codes. (Paragraph 97)

18. *Professor Kay's Good Practice Statements should be the standard level of behaviour for the industry and all players in the UK equity market. We expect the Government, in its response to this Report, to outline its timetable for all companies to sign up to Professor Kay's Good Practice Statements. If this target is not met, the Government should be prepared to incorporate Professor Kay's Good Practice Statements into the already established Stewardship Code. (Paragraph 98)*

Resourcing stewardship

19. *The attitude of 'do the minimum possible' found in many of our institutional investment firms has hindered the development of good stewardship. Asset managers are currently allowed to use commissions to pay for long-term research, including long-term stewardship, but it appears that few are aware of this. We therefore recommend that the Financial Conduct Authority contacts all major institutional investors highlighting that long-term investment research that is orientated towards good stewardship could (and should) be paid for using a proportion of equity commissions reserved for research. Furthermore, we recommend that the FCA sets and publishes an appropriate minimum proportion of a firm's commission allocated to research that should be used towards such activities and an annual list of those firms which do not achieve that level. Those firms will be expected to comply or explain why they have not dedicated the recommended proportion of resources on good long-term stewardship. (Paragraph 104)*

The Financial Transaction Tax

20. *There was some support for the concept of a Financial Transaction Tax on trading practices such as High Frequency Trading. However, concerns were raised about the practicality of implementing such a tax unilaterally. We recommend that the Government considers the viability, benefits and risks of a Financial Transaction Tax and commissions research in the following areas:*
- *An impact assessment of the introduction of a Financial Transaction Tax on equities at a level which is the average profit made on a High Frequency Trade in the UK.*
 - *A impact and feasibility study of the proposal to ban any of those banks which establish branches or subsidiaries in an offshore centre that does not adhere to the OECD's white list of financially compliant economies from trading in the UK. This should include an assessment of whether doing so would counter the arguments against a domestic FTT being ineffective in the global market. (Paragraph 113)*

Mergers and acquisitions

21. *Professor Kay recommended that the Government should take a more ‘sceptical’ view of the benefits of large takeovers and should be much more proactive in its monitoring of such activity. He drew particular attention to the relative vulnerability of UK companies to takeovers by foreign actors. We recommend that the Government conducts and publishes an assessment of the take-over regimes of other similar economies with a view to learning about the impact that takeovers have had on their companies and economies. Furthermore it should summarise which positive elements may be incorporated into our domestic system to strengthen our economy and ensure that takeovers benefit, rather than damage our economy. (Paragraph 119)*
22. *The Government has accepted Professor Kay’s recommendation on mergers and acquisitions but it is unclear what specific action it will take. We recommend that the Government clarifies what actions it will take over the next six months to be in a position to effectively monitor all merger activity in the UK. In its response to us, the Government should outline what action it will take to engage with companies and their investors to ensure that any investment merger activity is to the long-term benefit of the UK economy. (Paragraph 120)*
23. *We have heard evidence that the ‘one-share one-vote’ is fairest. Some witnesses pointed out to us that the long-term shareholders must choose to sell to short-term traders and argued that the ‘market’ ruled. However we cannot help but think back to the evidence that we have heard that, overall, takeovers detract value from companies. The Secretary of State told us that his instinct was to go back and consider introducing differential votes (i.e. encouraging the principle that short-term traders should have no influence over the takeover vote). (Paragraph 125)*
24. *We recommend that the Department produces a feasibility study which clearly outlines the risks and benefits of introducing a policy that differentiates between shareholders and voting rights based on the length of time a share has been held. (Paragraph 126)*
25. *We further recommend that the Government commissions a study to set out the impact on the UK of foreign takeovers of British companies over the past 25 years. (Paragraph 127)*

Measuring success

26. *Lord Myners’ Review was published more than a decade ago and yet we find ourselves examining the same issues and principles in the Kay Review today. Professor Kay’s findings and proposals must not be ‘kicked into the long grass’ by the Government or the industry. Professor Kay’s specific recommendations need to be acted on and we will hold those responsible to account. Where Professor Kay has provided overarching principles these need to be turned into actions. The Secretary of State has assured us that there is an appetite for change in the Government and we have heard that this is mirrored in the industry. Therefore, there can be no excuse for inaction by either the Government or the industry. (Paragraph 134)*
27. *We recommend that the Government immediately publishes clear, measurable and achievable targets for implementation of the Kay Review. In particular, in its response*

to this Report, the Government must outline for each of Professor Kay's 17 recommendations what needs to have been achieved by the Government's review of progress in 2014. (Paragraph 135)

Regulatory or voluntary approach

- 28.** We sympathise with Professor Kay and the Secretary of State's concerns that over prescription and formal legislation risk alienating the UK equity market in a global environment, providing false security through 'tick-boxing' and distorting the effective operation of the market. However, we have yet to be convinced that all of the major players in the institutional investment sector are committed to significant voluntary reform. (Paragraph 144)
- 29.** *We agree that the industry should be given a chance to change of its own volition but the experience of the Myners Review does not fill us with confidence. A cultural change will not happen without a catalyst. Ministers must be willing, and seen to be willing, to pick up a 'regulatory stick' should progress stall. We reiterate our recommendations that the Government has to set out a timetable for reform which includes the following for every one of Professor Kay's recommendations:*
- *a clear measure of success for the recommendation (the target);*
 - *who is responsible for achieving the target;*
 - *a clear deadline by which the target needs to be achieved; and*
 - *the action that the Government will take if the target is not achieved.* (Paragraph 145)

7 Annex A: Professor Kay's Principles

1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance;
2. Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements;
3. An investors' forum should be established to facilitate collective engagement by investors in UK companies;
4. The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves;
5. Companies should consult their major long-term investors over major board appointments;
6. Companies should seek to disengage from the process of managing short-term earnings expectations and announcements;
7. Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden;
8. Asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund;
9. The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers;
10. All income from stock lending should be disclosed and rebated to investors;
11. Mandatory IMS (quarterly reporting) obligations should be removed;
12. High quality, succinct narrative reporting should be strongly encouraged;
13. The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations;
14. Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment;
15. Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be

provided only in the form of company shares to be held at least until after the executive has retired from the business;

16. Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund; and
17. The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.²⁶⁴

264 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 12

8 Annex B: Summary of the Kay Review's recommendations

In his final Report, Professor Kay made 17 recommendations. Each of these is outlined below,²⁶⁵ followed by a summary of the government response:

1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance;

*The FRC regularly reviews the implementation and impacts of its Codes, and will produce its next report on developments in Corporate Governance and Stewardship in December this year. In light of this and future exercises it will consider whether further changes to the Stewardship Code may be desirable in due course to reflect Professor Kay's recommendation.*²⁶⁶

2. Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements;

*The Government supports this recommendation. The development and promotion of good practice in the investment chain is central to achieving the culture shift that Professor Kay advocates. Professor Kay's suggested Good Practice Statements—aimed at company directors, asset managers and asset holders in turn—provide a starting point from which to achieve this.*²⁶⁷

3. An investors' forum should be established to facilitate collective engagement by investors in UK companies;

*The Government intends to ask a small group of respected senior figures from business and the investment industry to review industry progress, including that made by institutional investors on shareholder engagement, both collectively and individually, and to assess companies' perception of the extent and quality of this engagement. This review will complement the Government's progress report in Summer 2014.*²⁶⁸

4. The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves;

²⁶⁵ Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 13

²⁶⁶ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.5

²⁶⁷ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.6

²⁶⁸ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.18

*The Government accepts this recommendation, and welcome Professor Kay’s thoughtful analysis of the impact of mergers and acquisitions on UK companies.*²⁶⁹

5. Companies should consult their major long-term investors over major board appointments;

*The Government agrees with the Kay Report that efforts by companies to consult their shareholders in advance of making major appointments to the board is consistent with developing long-term trust-based relationships that support engagement in pursuit of sustainable value creation. The establishment of an investor forum, as suggested by Professor Kay, may provide a means for such consultation to take place, but it need not be the only means. Many companies already consult shareholders on board appointments in the context of wider engagement activity and this is to be welcomed.*²⁷⁰

6. Companies should seek to disengage from the process of managing short-term earnings expectations and announcements;

*The Government supports this recommendation, which again represents good practice for companies. This recommendation has also been appended to the Good Practice Statement for Company Directors published alongside this response.*²⁷¹

7. Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden;

*The Government accepts the view that there should be common minimum standards of behaviour required of all investment intermediaries, but believes that describing these standards as ‘fiduciary’ has the potential to cause some confusion.*²⁷²

8. Asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund;

*The Government agrees with Professor Kay that there should be transparency of all costs and charges in the investment chain and are therefore supportive of this recommendation. This recommendation is reflected in the Good Practice Statement for Asset Managers, signalling Professor Kay’s intention to improve transparency through the development of industry good practice.*²⁷³

²⁶⁹ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.19

²⁷⁰ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.28

²⁷¹ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.31

²⁷² Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.34

²⁷³ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.37

9. The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers;

*The Government [...] accepts this recommendation and has asked the Law Commission to undertake a review of the legal obligations arising from fiduciary duties (and more widely) that dictate what considerations are appropriate for trustees and other investment intermediaries seeking to act in their clients' best interests.*²⁷⁴

10. All income from stock lending should be disclosed and rebated to investors;

*The Government supports this approach and would like to see separate disclosure of stock lending costs and income endorsed by the industry in the context of the development of a more comprehensive industry-led disclosure regime, as discussed above. The Government's progress report in Summer 2014 will assess to what extent the investment industry has responded to this recommendation and what further action might be appropriate in the context of relevant EU policy developments in this area.*²⁷⁵

11. Mandatory IMS (quarterly reporting) obligations should be removed;

*The Government has already made clear its strong support for the [European] Commission's proposal [to amend the EU Transparency Directive] and will therefore take forward work to deliver this recommendation in the context of ongoing negotiations with the Commission and EU Member States. UK implementation of the proposed changes would fall to the FCA and be subject to consultation and cost-benefit analysis.*²⁷⁶

12. High quality, succinct narrative reporting should be strongly encouraged;

*The Government supports this recommendation. We are already focused on this policy objective, which was the subject of a Coalition Government commitment, and have carried out two consultation exercises in the past two years. [...] The Government published draft regulations to bring about the changes to the structure and format of reporting on 18 October 2012, with the intention of bringing these into effect in October 2013. We will be working closely with the FRC as they develop the guidance on the new provisions.*²⁷⁷

13. The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations;

The Government will [...] explore with market participants, the regulators, academics and relevant representative and professional bodies how best to stimulate more debate

²⁷⁴ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.44

²⁷⁵ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.50

²⁷⁶ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.51

²⁷⁷ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, paras 3.53 & 3.56

*and economic analysis in this area. We expect to set out further proposals early in the new year.*²⁷⁸

14. Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment;

*Recommendation 14 has potentially wide-ranging implications for regulatory policy and will therefore be considered in more detail by the relevant government departments and independent regulators, alongside the broader directions for regulatory policy.*²⁷⁹

15. Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business;

*The Government agrees that the structure of remuneration should be determined by individual companies in consultation with their shareholders and that agreeing and sharing good practice is the appropriate way to promote change in this area. The Government does not believe there is a case for blanket regulation of the structure of company directors' remuneration and believes that companies and their shareholders need flexibility to negotiate outcomes that work for them. The Government's comprehensive reforms to the governance framework for directors' remuneration will help to support change in this area.*²⁸⁰

16. Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund;

*Professor Kay's stated intention to shift the culture of asset manager pay through the development of industry good practice, rather than by imposing pay structures in regulation. Recommendation 16 is therefore reflected in the Kay Good Practice Statement for Asset Managers. The Government will encourage asset managers to adopt such models by promoting consideration of the Kay Good Practice Statement for Asset Managers.*²⁸¹

17. The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.

²⁷⁸ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.59

²⁷⁹ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.60

²⁸⁰ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.64

²⁸¹ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.68

The Government believes reducing intermediation costs and removing barriers to direct engagement for individuals wishing to hold shares electronically is a desirable policy objective. It will however be necessary to address this recommendation in the context of policy proposals relating to central securities depositories and securities law in the EU. This will include consideration of future arrangements for how investors can hold shares in a way that increases shareholder transparency and facilitates them exercising their shareholder rights, under the requirements set out in any final EU legislation.²⁸²

²⁸² Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The government response to the Kay Review*, November 2012, para 3.70

9 Annex C: Professor Kay's Good Practice Statements

Good Practice Statement for Asset Managers

Asset Managers should...

1. Recognise that they are in a position of trust managing client money and should act at all times in the best long-term interests of their clients, informing them of possible conflicts of interest and avoiding these wherever possible.
2. Operate within a culture of open dialogue with their clients – building an agreed understanding of investment objectives and risks, which is informed by their investment expertise.
3. Provide information to clients, including information on investment performance, in a way which is clear, timely, useable and relevant to the long-term creation of value in the investee companies, and therefore to clients' investment objectives.
4. Disclose fully all costs that fall on investors in a way that investors can understand.
5. Ensure that income generated from lending securities is rebated in full to the fund, with any related costs disclosed separately.
6. Adhere to the investment strategy agreed with clients.
7. Prioritise medium to long-term value creation and absolute returns rather than short-term returns from market movements when making investment decisions.
8. Build an ongoing relationship of stewardship with the companies in which they invest to help improve long-term performance – recognising that engagement goes beyond merely voting.
9. Make investment decisions based on judgments about long-term company performance, informed by an understanding of company strategy and a range of information relevant to the specific company, and avoiding reliance on single measures of performance.
10. Be prepared to act collectively to improve the performance of their investee companies.
11. Be paid in line with the interests and timescales of their clients. Specifically remuneration should not be related to short-term performance of the investment fund or the performance of the asset management firm. Instead, a long-term performance incentive should be provided in the form of an interest in the fund

(directly or via the firm) to be held until the manager is no longer responsible for that fund).²⁸³

Good Practice Statement for Asset Holders

Asset Holders should...

1. Recognise that they are in a position of trust managing client money and should act at all times in the best long-term interests of their clients, informing them of possible conflicts of interest and avoiding these wherever possible.
2. Operate within a culture of open dialogue with beneficiaries – building an agreed understanding of investment objectives and risks.
3. Provide information to beneficiaries, including information on investment performance, in a way which is clear, timely, useable and relevant to clients' investment objectives.
4. Be proactive in setting mandates for asset managers based on open dialogue about agreed investment objectives.
5. Set mandates which focus managers on achieving absolute returns in line with beneficiaries' long-term investment objectives, rather than short-term relative performance benchmarks.
6. Recognise that diversification is the result of diversity of investment styles.
7. Review performance no more frequently than is necessary, and with reference to long-term absolute performance.
8. Encourage and empower asset managers to engage with investee companies as a means of improving company performance to deliver investment returns.²⁸⁴

Good Practice Statement for Company Directors

Company Directors should...

1. Understand their duties as directors under the Companies Act 2006, and in particular acknowledge the relevance of considering long-term factors, including relevant environmental, social and governance issues, and the reputation of the company for high standards of business conduct, in fulfilling their duty to promote the success of the company.
2. Acknowledge that long-term value creation in the interests of shareholders is best served by strategies which focus on investing appropriately to deliver sustainable performance rather than treating the business as a portfolio of financial interests.

283 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 53

284 Professor Kay, *The Kay Review of UK equity markets and long-term decision making*, July 2012, page 56

3. Act to ensure that the intermediation costs associated with a publicly traded company are kept to a minimum.
4. Ensure that corporate reporting is focused on forward looking strategy.
5. Facilitate engagement with shareholders, and in particular institutional shareholders such as asset managers and asset holders, based on open and ongoing dialogue about their long-term concerns and investment objectives.
6. Provide information, in the context of corporate reporting and ongoing shareholder engagement, which supports shareholders' understanding of company strategy and likely long-term creation of value, including by agreeing a range of performance metrics relevant to the company.
7. Communicate information to shareholders which aids understanding of the future prospects of the company, even if this means going beyond (but not against) the strict requirements of accounting standards, for example on market valuations.
8. Not allow expectations of market reaction to particular short-term performance metrics to significantly influence company strategy.
9. Refrain from publishing or highlighting inappropriate metrics which may give a misleading impression of anticipated future company performance.
10. Be paid in a way which incentivises sustainable long-term business performance: long-term performance incentives should be provided in the form of company shares to be held until after the executive has retired from the business.²⁸⁵

Formal Minutes

Tuesday 16 July 2013

Members present:

Mr Adrian Bailey, in the Chair

Mr Brian Binley	Rebecca Harris
Paul Blomfield	Ann McKechin
Mike Crockart	Mr Robin Walker
Caroline Dinenage	Nadhim Zahawi

Draft Report (*The Kay Review of UK Equity Markets and Long-Term Decision Making*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 145 read and agreed to.

Summary and annexes agreed to..

Resolved, That the Report be the Third Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for printing with the Report in addition to that ordered to be reported for publishing on 29 January, 19 March, and 2 July 2013.

[Adjourned till Tuesday 3 September at 10.00 am

Witnesses

Tuesday 5 February 2013

Page

Professor John Kay, Chair of the Review of UK Equity Market and Long-Term Decision Making

Ev 1

Tuesday 14 February 2013

Lord Myners CBE, Former Financial Services Secretary and author of *Institutional Investment in the United Kingdom: A Review*

Ev 15

Tuesday 26 February 2013

Catherine Howarth, Chief Executive Officer, FairPensions, **Christine Berry**, Head of Policy and Research, FairPensions, **Simon Wong**, Visiting Fellow, LSE and Partner, Governance for Owners, and **Dr Paul Woolley**, Head of the Paul Woolley Centre for the Study of Capital Market Dysfunctionalities

Ev 31

Dominic Rossi, Global Chief Investment Officer, Fidelity Worldwide, **Anne Richards**, Global Chief Investment Officer, Aberdeen Asset Management, **Harlan Zimmerman**, Senior Partner, Cevian Capital, and **Roger Gray**, Chief Investment Officer, Universities Superannuation Scheme

Ev 40

Tuesday 5 March 2013

Anita Skipper, Corporate Governance Adviser, Aviva Investors, **Steve Waygood**, Chief Responsible Investment Officer, Aviva Investors, **Neil Woodford**, Head of UK Equities, Invesco Perpetual, and **Chris Hitchen**, Member of Kay Advisory Board Team and Chief Executive, Railpen

Ev 53

Daniel Godfrey, Chief Executive, Investment Management Association, **Guy Sears**, Director, Institutional, Investment Management Association, **Penny Shepherd**, Chief Executive, UK Sustainable Investment and Finance Association, and **Matthew Fell**, Director of Competitive Markets, Confederation of British Industry

Ev 65

Tuesday 26 March 2013

Rt Hon Vince Cable MP, Secretary of State for Business, Innovation and Skills

Ev 74

List of printed written evidence

1	The Government	Ev 85; Ev 170
2	Aberdeen Asset Management plc	Ev 168
3	Albion Ventures LLP	Ev 89
4	Association of General Counsel and Company Secretaries of the FTSE 100	Ev 115
5	Aviva plc	Ev 99; Ev 106
6	BlackRock	Ev 127
7	BT Pension Scheme Management Ltd (BTPSM), Universities Superannuation Scheme (USS) Limited and Railpen Investments (RPMI)	Ev 120
8	Cevian Capital	Ev 160
9	Chartered Institute of Personnel and Development (CIPD)	Ev 137
10	Fidelity Worldwide	Ev 162; Ev 162
11	Financial Reporting Council	Ev 170
12	Philip Goldenberg	Ev 86
13	Investment Management Association	Ev 146
14	National Association of Pension Funds Limited	Ev 122
15	PIRC Analysis of Voting on Director Elections 2009 to 2012	Ev 158
16	Quoted Companies Alliance	Ev 125
17	Russell Investments	Ev 91
18	ShareAction (formerly FairPensions)	Ev 107; Ev 113
19	Standard Chartered Bank	Ev 87
20	Tomorrow's Company	Ev 143
21	UK Shareholders Association	Ev 134; Ev 136
22	UK Sustainable Investment and Finance Association (UKSIF)	Ev 141
23	USS Investment Management Limited	Ev 166
24	Dr Paul Woolley	Ev 163

List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2013–14

First Report	Women in the Workplace	HC 342-I/II/III
Second Report/First Joint Report	Scrutiny of Arms Exports and Arms Control (2013): Scrutiny of the Government's UK Strategic Export Controls Annual Report 2011 published in July 2012, the Government's Quarterly Reports from October 2011 to September 2012, and the Government's policies on arms exports and international arms control issues	HC 205

Session 2012–13

First Report	The Hargreaves Review of Intellectual Property: Where Next?	HC 367-I/II(HC 579)
Second Report/First Joint Report	Scrutiny of Arms Export Controls (2012): UK Strategic Export Controls Annual Report 2010, Quarterly Reports for 2010 and January to September 2011, the Government's review of arms exports to the Middle East and North Africa, and wider arms control issues	HC 419
Third Report	Post Office Network Transformation	HC 84(HC 678)
Fourth Report	Overseas Students and Net Migration	HC 425(Cm 8557)
Fifth Report	Apprenticeships	HC-I/II/III(HC 899)
Sixth Report	The Insolvency Service	HC 675 (HC 1115)
Seventh Report	Too Little, Too Late: Committee's observations on the Government Response to the Report on Overseas Students and Net Migration	HC 1015(Cm 8622)
Eighth Report	Pre-appointment hearing of the Government's preferred candidate for the post of Groceries Code Adjudicator	HC 1011
Ninth Report	Local Enterprise Partnerships	HC 598(HC 585)

Session 2010–12

First Report	The New Local Enterprise Partnerships: An Initial Assessment	HC 434 (HC 809)
Second Report	Sheffield Forgemasters	HC 484 (HC 843)
Third Report	Government Assistance to Industry	HC 561
Fourth Report / First Joint Report	Scrutiny of Arms Export Controls (2011): UK Strategic Export Controls Annual Report 2009, Quarterly Reports for 2010, licensing policy and review of export control legislation	HC 686
Fifth Report	Government Assistance to Industry: Government Response to the Committee's Third Report of Session 2010–11	HC 1038

Sixth Report	Is Kraft working for Cadbury?	HC 871
Seventh Report	Rebalancing the Economy: Trade and Investment	HC 735 (HC 1545)
Eighth Report	Trade and Investment: China	HC 1421 (HC 1568)
Ninth Report	Time to bring on the referee? The Government's proposed Adjudicator for the Groceries Code	HC 1224-I
Tenth Report	Pub Companies	HC 1369-I/II (Cm 8222)
Eleventh Report	Time to bring on the referee? The Government's proposed Adjudicator for the Groceries Code: Government Response to the Committee's Ninth Report of Session 201-12	HC 1546
Twelfth Report	Government reform of Higher Education	HC 885-I/II/III (HC 286)
Thirteenth Report	Pre-Appointment Hearing: Appointment of Director of the Office for Fair Access	HC 1811
Fourteenth Report	Debt Management	HC 1649 (HC 301)
Fifteenth Report	Stamp Prices	HC 1841-I/II

Oral evidence

Taken before the Business, Innovation and Skills Select Committee

on Tuesday 5 February 2013

Members present:

Mr Adrian Bailey (Chair)

Paul Blomfield
Rebecca Harris

Ann McKechin
Robin Walker

Examination of Witness

Witness: **Professor John Kay**, Chair of the Review of UK Equity Market and Long-Term Decision Making, gave evidence.

Q1 Chair: Can I thank you and welcome you, Professor Kay? Could we just start by letting you introduce yourself for voice transcription purposes?

Professor Kay: I am John Kay, author of the review of equity markets and long-term decision making.

Q2 Chair: I will start off with a fairly general question. In your analysis, you basically downgraded the role of equity finance in terms of business capital investment. However, there did seem to be some contradictory evidence from the Quoted Companies Alliance. Could you tell us whether equity markets remain an essential source of capital for new investment in British business? What are your thoughts? Coming from your perspective, and that of the Quoted Companies Alliance, what do you think is the right sort of balance of evidence?

Professor Kay: There are two ways of looking at it. One is to consider what has been raised over the last 20 years or so. We actually find that if we strip out the amounts that were subscribed in the rescue rights issues of British banks—most of it by the Government—then total new equity issuance has been negative, not positive. By that I mean that more shares have been bought back or removed from the market through people buying companies from cash than have been raised in new issues. In that sense, equity markets are not now a source of fundraising.

If I look at it from the other point of view, which is the question of where quoted companies actually get money from, the answer is that they are overwhelmingly now self-financing. If one examines British quoted business as a whole, it makes more cash flow from operations than it currently invests. We know that at the moment British companies, taken as a whole, are sitting on a large pile of cash, and that the vast majority of quoted companies are individually self-financing as well. When quoted companies go outside the company itself to raise new money in the markets, they have largely done it through debt, rather than through equity.

Q3 Chair: Could it be, though, that even though the overall figures indicate a diminishing role for equity finance, it is still, or has been, strategically very important for some companies?

Professor Kay: Rarely, I think. The other side of it, which causes me a lot of concern, was the observation

that successful small and medium-sized companies less and less regard getting public market quotation as a natural part of their development. Another reason for that is that business is less capital intensive than it was. We think of knowledge businesses as being the future, and these businesses may incur operating losses in their startup years, but they do not require huge quantities of physical investment. Equally, the kind of physical investment that we do need in business is now much more fungible than it was. It is property, computers, and that kind of thing, which can be provided through other ways than equity finance. I am not either applauding or deploring this. I am just describing what I think has happened.

Q4 Chair: I understand that. How did this affect your recommendations in the review?

Professor Kay: It took me to saying that “This is how things are, and, actually, I don’t think they are going to change very much.” Equity markets are, in this sense, fundamentally secondary markets. In a way, the tail has come to be much larger than the dog. Therefore, corporate governance and issues around that are not a small part of the way in which equity markets relate to corporate performance. They are actually a very large part of it; in some ways, they are the main thing that we should be looking at. As far as investment and decision making in business is concerned, what equity markets are doing in effect is, they are a way of supervising the investment decisions and the strategic decisions that are made by company management. That is the way we should look at it, and it is the way that I did look at it.

Q5 Chair: Given your position on this—and I think you have touched on this already, but if you could just spell it out—how do you see the role of the equity market in future?

Professor Kay: As things are at the moment, I see it probably playing a diminishing role. We have said that it is not an important source of finance for new business. We have said that it does not seem to be the case that new British companies are coming to market. One of the striking things, if you look down the list of new listings on the London Stock Exchange over the last five to 10 years, is that although it is quite a long list you will not find many ordinary, non-financial British companies on it. This is not the way

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that British business now seems to be growing and developing. There are a lot of reasons for regretting that, but that seems to be the way that things are now. We have put in place measures, partly through regulation and partly through other means, which mean that insurance companies and pension funds have a smaller proportion of their portfolios in equities than they used to. Of course, the pretty disappointing returns that savers have made from equity markets over the last 10 years have not made equity markets look exciting as a vehicle for savers in the way that they did in the 1980s and 1990s. At that time, just buying equities randomly was almost a way of making quite a lot of money.

Q6 Chair: This may perhaps be slightly beyond your terms of reference, but I have an observation arising from what you have just said, and I would be interested in your view on it. The larger companies are not turning to the equity market: they retain savings, and so on and so forth. Smaller businesses are finding it incredibly difficult to access capital from the banking service. Would you say that there is a structural failure in the market?

Professor Kay: Yes, I do. Our capital markets are not working well, in terms of their primary job of getting capital to businesses that need it. The critical requirement for small and medium-sized companies is to cover the operating losses of developing a business position, rather than, as I described, to buy plants and machinery and build factories, as was traditionally the case in the past. Banks never provided that much finance of that kind anyway, but we all know how little finance is now being provided for small and medium-sized companies.

As you say, this was not part of the terms of my review, but it is something about which I am very concerned, and plan to write about in what I am currently writing in terms of the financial services industry. It is one of the biggest problems we have in relation to the functioning of UK capital markets. What I would like to see would be the development of new specialist institutions that were more oriented to the provision of equity or near equity capital than the banks traditionally have been. They would perhaps be a bit like the venture capital industry used to be, before it rather lost its way and became private equity, and much more interested in buyouts of established businesses.

Chair: I think it is likely that the Committee would love to pursue this line of questioning.

Professor Kay: Whether it is today is another matter.

Chair: It perhaps takes us rather beyond our remit. However, if you are writing about it, it is certainly quite possible that we will be doing a future inquiry into this, so we will invite you to expand further on that.

Professor Kay: I would be happy to come back, I am sure.

Q7 Chair: In the meantime, I will watch the outcome of your deliberations with some interest. I would now like to move onto the international context and the market. Your analysis found that the owners of more than 40% of UK shares are based outside of the UK.

How do you think that that has affected corporate governance and stewardship of UK companies?

Professor Kay: We have brought in a group of people who, for various reasons, are rather more reluctant than UK institutions used to be to involve themselves in the governance and strategy of UK companies. There is a term that I would rather not use in all of this, which is “share ownership,” because, as I talk about in the report, exactly what we mean by “share ownership” is quite a difficult question. I have described critical players in this today as being “asset managers”, and so our equity market is now dominated by large asset managers. Some of these are American firms like Fidelity, Capital, BlackRock and Vanguard. Some of them are British firms like Legal & General and M&G. Those are the biggest beasts in the equity market scene.

A lot of the funds that they manage are ultimately funds that originate outside of the UK. Many, although not all, of the funds that they are managing—whether they are American or British—are funds that originate within the UK. The picture is more complicated than the ONS statistics on share ownership, for instance, suggest. The basic element in this is that there are more foreign beneficial holders of UK equities, and there are more foreign-based asset managers in the market, than there were 20 years ago. There is also an element of sovereign wealth fund involvement in this, of which Norway and Singapore are the largest.

Many of these people are more reluctant to get involved in governance and strategy of UK companies than British institutions used to be. This is perhaps because that is not the way that Americans tend to operate; historically, Americans are more reluctant to work together than UK institutions. As with the sovereign wealth funds, they are a bit scared of getting involved in UK business. That is what led me to write that one of the things I would like to do would be for the British Government to say that, “For the people we are talking about, we would welcome greater involvement and collective involvement in British business on their part.”

Q8 Chair: You have anticipated my next question.

Professor Kay: Sorry.

Chair: That is fine. The question was to be whether this is good or bad. I would gather that, from your perspective, you think that greater involvement of such funds in British business would actually be a positive, rather than a negative, influence.

Professor Kay: I think that it would, if it is the right kind of involvement. A lot of people talked about the merits of greater shareholder involvement. One needs to be a little bit cautious about that, because we have had rather negative shareholder involvement in many ways. I talked, for example, in the report about some of the signature examples of things going badly wrong in large British companies: the disappearance, essentially, of ICI and GEC, for example. The truth is that the breakups that led to the ultimate collapse and disappearance of these companies were encouraged by shareholders. Indeed, if these companies had not been as oriented towards equity markets as they were, it is unlikely that these developments would have

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occurred. The kind of shareholder involvement that is about making shortterm gains from restructuring and refinancing, rather than promoting the longterm operating capabilities of the business, is negative, not positive. That is why I think that we have to look, at the same time, at the style of asset management that asset managers deploy.

Q9 Chair: You state that the “general direction of our recommendations to asset holders and asset managers should, overall, be helpful to smaller companies”. Could you elaborate on this?

Professor Kay: What we would like to see is longerterm, more concentrated portfolios by asset managers who take a strong interest in the companies in which they invest. We were talking a few moments ago about small and mediumsized businesses, and their funding problems. In my view, that is exactly the kind of funding that the typical small and mediumsized business is in need of, and is the kind of funding that is not currently very well provided through public markets in many cases.

Q10 Paul Blomfield: I wonder if we could reflect a little on where we go now. In drawing your report to a conclusion, you talk about the challenge ahead and say that the task will be “long and difficult. But it is time to begin.” Who do you think should be picking up the ball, and how well do you think they are doing it?

Professor Kay: There are a whole range of people who should be picking up the ball. Government should clearly be picking up the ball, but there are limitations to what the Government can do. There are two very fundamental ways in which Government can contribute. One is that Government, and you as politicians, have a huge effect in setting the tone of public debate. If we are trying to change the way that people think about markets and the relationship between markets and companies, the way in which we have a public dialogue about that is terribly important. The second—and this is described a bit in the report—is that a lot of our regulation of financial markets has gone quite badly wrong. Let me make clear that I am not against financial market regulation. However, I think we have gone far too far down the specification of detailed rules. We have also tended to view financial markets through the eyes of people in financial markets. There is something extraordinarily selfreferential about both the ways in which people in public markets talk and the ways in which we regulate them. We need to reverse that, and say that markets are for users and should be judged by how well they serve users, not by criteria that are essentially generated by the market itself. That, over the long run, is a big shift. At the moment, if anything, we are going in the wrong direction, rather than the right one, in relation to that issue.

Chair: The purpose of this inquiry is to develop that process.

Q11 Paul Blomfield: Giving that responsibility to Government, and recognising its limitations, how well do you feel that the Government have responded to the challenge that you have set?

Professor Kay: It is hard to say at this point. The tone of the Government response, in relation to the two issues that I have just described, was more positive than I had anticipated. I was fearful—and am still fearful—of more push-back from established, vested interests in the financial services industry.

Q12 Paul Blomfield: What about the response from other players?

Professor Kay: The response from asset managers and investment managers has been mixed, but, in the main, pretty positive. I got a strong sense during the work on the review—and it has been confirmed afterwards—that a high proportion of the asset management community would actually like to go down the directions that we are describing. They feel inhibited in doing it by the demands of their customers and by the whole regulatory and market environment in which they are operating. That is why we have to go about making a whole set of piecemeal changes—in tone and in regulation—to try and shift things in the directions that we want to go.

Q13 Paul Blomfield: As a different reflection on your report, you provided a fairly fundamental critique of markets. In response to the Chair earlier you talked about structural failure, or concurred with that view. In that context, there has been some criticism that the report is fairly timid; one commentator said that it whets the appetite for a further report that specifies more of what might be done. How do you respond to that?

Professor Kay: I can see a sense in which that is right, if one is talking about a 20year process of change and reform. The kinds of markets that we have today are the product of a long history. One can see the changes in the 1970s and 1980s that set the way for the financial services industry that we now have. If it is a long process, then it is probably right to say that we are starting to push in a different direction and creating a vision of where we would like to be. That is why I welcomed one aspect of the Government’s response, which was to say, “We will look at this issue again, and see whether we are starting to make progress in the right kind of ways”. That is a sensible way to look at it. What I have said explains, in a way, why we did not do what a number of people would have liked us to do, which would be to set out a raft of detailed regulatory changes and recommendations. I really do not think that would have been helpful in setting the kind of change in tone and direction that I would be seeking.

Q14 Paul Blomfield: You make a strong critique in your report of the limitations of regulation, so I understand where you are coming from. However, one commentator in the FT said that, of your 17 recommendations, only four could really be described as substantial. In the comments you just made a moment ago, you seemed to suggest that you felt you could have gone further. Is that fair?

Professor Kay: Yes. Let me take a radical example: we are in a bit of a mess about insider trading rules. That is a subject where we have not quite thought about what we are doing, and is a classic case in

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which we are tending to view the issue through the eyes of market participants, rather than the ultimate users of markets. I could have said more about that, but I do not think that either financial market opinion or public opinion is yet ready to rethink the way in which we view these kind of issues. We have to move step by step.

Q15 Paul Blomfield: What would you see as future steps? Taking that one example, if public opinion was right, what else would you like to see?

Professor Kay: If one elaborates on that example, what we do at the moment is that we conflate together the kind of fraud involving a guy sitting in a boardroom, and ringing up his hedge fund friend to tell him what to buy and sell when he comes out of the boardroom—these kinds of people ought to be in prison, and we ought to be focusing on how we get tougher enforcement action so that we can get people who do these kinds of things behind bars where they ought to be—with a raft of regulatory and compliance issues that we have, which I think is a different matter. These are the issues that regulate the kinds of interactions that asset managers can have with the companies in which we invest. We are, in effect, saying at the moment that we really want asset managers to engage more forcefully with the companies in which they invest, but if they do, and gain any informational advantage, they may not trade on it. There is a paradox there. I do not believe it is either possible or desirable to say that we will have markets in which everyone is trading on the basis of uniform information.

Q16 Chair: Before I move on to Ann McKechin, could I just put it to you that you have outlined the problems, you have not made that many robust recommendations, but in your evidence to us today—and I hope I am summarising it fairly—you say that too often Government sees regulation through the eyes of the industry? Surely part of your role was to provide the Government with a counterargument that it could use as a basis for introducing a greater degree of intervention. There does seem to be a lacking in your recommendations of the kind of detail that would enable them to do so. How would you respond to that?

Professor Kay: I see what you are saying. First of all, I do not want more regulation. I really want less, in fact, because we have gone down what I sometimes think is a Soviet Union-type road of introducing regulations and, when they do not work very well, making them more elaborate. We then go on, getting more and more frustrated at the fact that they do not work very well. In a way, I would like to see less regulation of financial services, rather than more.

However, what we ought to be aiming at are things that are the products of different kinds of behaviour. For example—and this is a very important one—a lot of the damage is being done by the way in which asset holders and retail savers are judging, and are being encouraged to judge, fund managers and asset managers on the basis of their very short-term performance. Everyone is going through the business of getting quarterly performance reporting, sometimes more often than that, and having the kind of

discussions in which people say, “Why were you 1% behind the benchmark in the last three months?” and so on. I do not think I can introduce regulations that would stop people doing that. Just try and frame the regulation; you cannot do it. Indeed, there is an almost human tendency to try to look at performance terribly often. I know that, now I can press a button on my computer and get the value of my share portfolio at any moment of any day, I quite often do that, even though I know that it is not giving me any useful information.

I do not think we can regulate people to do that. However, what we can do is say to people that it is not good practice, and that hauling your fund manager over the coals every three months and asking why they underperformed last week is not you doing your job conscientiously. It is bad practice. It is not in the long-term interest of your beneficiaries to have that kind of inquiry, because it leads to fund manager behaviour that is short-term, inappropriate, and stimulates them to look at markets and the performance of markets, rather than the underlying performance of companies. That is why I thought that the right way of doing that is to try to tell people what good practice is, so that they can say to their asset managers—as I hope they ultimately would—“Here is some money. Come back after a period of years, and tell me how you have performed with it, because I cannot judge you except over that period of years.” That is not negligent. It is what people ought to be doing.

Q17 Chair: It sounds a bit like the financial equivalent of motherhood and apple pie. Telling people what good practice is, and so on, is very different from actually getting an industry that, by and large, does not seem to put the adoption of good practice at the top of its agenda to do so. Surely there must be some means by which the Government could exercise a monitoring role that would not need a whole raft of detailed regulation.

Professor Kay: Let us look at the example of what has happened in this area, by putting more responsibility on pension fund trustees to monitor the performance of their asset managers and their underlying companies. We have done two things. One is that we have created this market for investment consultants, who are themselves the source of quite a lot of this short-termist behaviour, because they are typically making recommendations to trustees based on recent performance histories, rather than the future approach and strategy of the manager. In addition, we have encouraged trustees to think that they have to be going through this regular routine of performance management. By saying we are monitoring the performance of pension fund trustees more carefully and imposing more obligations on them, which sounds as if it is moving in the right direction, we have in fact done the opposite.

If we want to establish trust relationships as the basis of financial services—and I believe we do—we cannot regulate trust relationships very easily. We need to set up structures and environments in which people can develop them and in which they are encouraged to develop them, rather than the one we have at the

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moment in which people are going through large amounts of compliance-based form-filling and box-ticking.

Q18 Chair: Surely that is because the compliance criteria are wrong. If those were altered, then that could surely change.

Professor Kay: This is where I come back to wanting to set out these generalised statements of good practice. I do not see how I can enforce these. What we have ended up in large part doing—in the corporate governance sphere, for example—is that we have set out what everyone in the corporate sector calls “box-ticking”, in which people are devoting lots of time to worrying about how long non-executive directors have been on the board. These things are not trivial, but they are not much to do with what has really gone wrong in those British companies where things have really gone wrong. GEC did not blow up because it did not have the right lengths of service or experience of non-executive directors. It blew up because of very fundamental misconceptions about the relationship between financial markets and business.

Q19 Chair: Can I just pick up one point that you made, in terms of directors’ remuneration and incentives? I will quote you: “Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business”. I understand what you are trying to say there, but could that not be contradictory, insofar as it might provide an incentive for a higher turnover of directors who would basically take their cash and run when it suited them?

Professor Kay: That is possible. I do not think it would happen very much. Back in this area—as in the area that we have just been talking about—what we want is people running large companies who derive their main satisfaction from their sense of how they have built the company over a period of years. That is what British managers traditionally did, before we started an elaborate and counter-productive process of supposedly aligning their interests with those of shareholders through these complicated bonus and incentive schemes. The people who built the great British businesses of the past—the ICIs, the Shells, the Unilevers and so on—were motivated by the thought that they were building great businesses, and they were. These people did not really think about the share price much. I would like to get back to managers having much more of that kind of approach and attitude.

Q20 Mr Walker: On that point, and on the point about management incentives supposedly aligning with shareholders, do you think that change in culture has made managers of businesses more inclined to sell and take a profit when they can?

Professor Kay: It has certainly made them much more financially inclined, interested in M-and-A-type strategies and restructurings, and a whole variety of issues that are not very closely related to the underlying competitive strengths of the business.

Q21 Ann McKechin: Good morning, Professor Kay. I wonder if you could perhaps give me your opinion of whether there is any added value in having a non-enforceable stewardship code, which is what we currently have?

Professor Kay: Yes, I think there is. We can do a lot to tell people what we regard as good behaviour and put pressure on them to do it, without actually pushing that into formal regulations. There are two disadvantages of framing these things in terms of formal regulations. One is that they are inflexible—not all of these regulations will be applicable to all situations and all companies. The other is that people will be inclined to believe that, so long as they have complied in a formal sense, then they have done their job.

We have seen a lot of examples in the financial services industry of regulation that has worked badly in these respects. The worst example is the capital requirements that we imposed—and, indeed, are now strengthening—on banks. That had essentially the effects I have described: people believed that, so long as they formally complied with the capital requirements, they were managing their risk properly. We know that, in fact, they were not. It also meant that people devised instruments that, in effect, got around the intended effect of the capital requirements. These things encourage formal compliance, rather than substantive compliance.

Q22 Ann McKechin: Some of the evidence given to our Committee—for example, from Aviva—talked about a free-rider problem. They said that good stewardship is a public good, and therefore that if you have one set of asset managers who exercise the code in the right spirit, then basically other asset managers can simply piggyback on that and do not have to bother. In that sense, is there not then a greater need for some form of baseline, and there being consequences for not complying with this baseline? Otherwise, what is the incentive for companies as a whole to improve?

Professor Kay: The freerider problem concerned me quite a lot, and it is discussed at length. That is, in part, why I wanted to introduce measures that made it easier for people to act collectively. In terms of baseline involvement, there is something to be said for that, but, again, it is quite difficult to enforce a low baseline meaningfully. We want asset managers to engage more forcefully and effectively with the companies in which they invest. It is really quite difficult to define what we mean by engagement of a constructive kind.

Q23 Ann McKechin: Do you think the Government should rewrite the code? You have mentioned the fact that you think that the code should be more strategic in its purpose. To what degree do you think Government should be engaged in trying to set that?

Professor Kay: Yes, I do, and that was one of the things I was trying to encourage through statements of good practice. If the industries do not develop these kinds of concepts of good practice, I would like Government to intervene and try to do it for them. However, to me, that is a second best, because what

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we are really trying to do is to influence people to start changing the way in which they behave. The best way to do that is to take advantage of the fact that most of them want to do it. You talked about Aviva. Most fund managers would actually like to move towards the kind of regime that we are describing. It is not because they are recalcitrant; it is because the structure of the environment in which they are operating does not encourage that kind of behaviour. That is why we have to make all of these moves in changing the culture in a way that will bring about the kind of behaviours that we want.

Q24 Ann McKechin: You have mentioned the fact that many asset managers would want to have greater involvement in management of the company. However, surely part of the code should be designed for the general public and savers so that they actually know what it means, and what they can and should expect from the people who are responsible for their savings. FairPensions have indicated that there is really a need for a clearer definition of stewardship. You have mentioned that defining parts of the Code is quite difficult in some ways, but would you agree that greater clarity might be of assistance?

Professor Kay: Yes, I do. I think that the good practice, the stewardship code, and so on, are all things that we would want to evolve over time. That, in a sense, is another reason for not making it too rigid and too inflexible. We want it to be an evolving and developing process.

Q25 Ann McKechin: If I could turn now to the good practice statements, which you have also mentioned in your report, they said that they should prompt market participants to consider their current practice, but will not have the force of regulation or formal guidance. If that is the case, who will be responsible for monitoring the compliance between the asset managers, the asset holders, and the company directors?

Professor Kay: Because they are good practice, I do not think that there is an issue of formal compliance. This is what we want people to do, and we are saying that many people want to do it. However, it is almost impossible to define the kind of engagement we want in terms of formal rules. It is almost impossible to define the kind of longtermist attitude that we want from company directors in terms of formal rules. If managers of large German companies typically have more longterm outlooks than managers of British companies, for example—and they do—it is not because there are different duties in German law to the ones in British law, or different regulations in the two countries. It is essentially because the structure of share ownership in Germany, and the attitudes of many of the large holders of stakes in German companies, are different from the equivalents in Britain. What brings about the difference is not a different regulatory structure or different company law, but a different set of attitudes to how businesses should develop. That is what we need to be focusing on.

Q26 Ann McKechin: We could say this about any business relationship, but, at the end of the day, what happens in the City has an impact on the savings, pensions and economic prosperity of every citizen of this country. Would you not reflect that there needs to be a degree of transparency? If somebody says, “We have a practice statement, and we believe that the outcomes will be X—this will be improved, and there will be some way in which we can give certain degrees of certainty about what we are aiming for, and we will report back to our shareholders or whoever on a regular basis about how we are achieving those outcomes in line with our good practice statement,” then people can see a direct correlation. At the end of the day, this just seems to be a whole other set of words that somebody stores carefully in the shelf and brings out from time to time to say, “We’ve got a good practice statement.” People want to find a way in which they can actually hold people to account for the way in which they are dealing with their money. This is what this is fundamentally about.

Professor Kay: That is right. However, we should then ask how, as savers, we are collectively going to do it. There are two things that we can do. One is, as savers, to place our money with people who adopt the right kind of practices in dealing with that money. That is both looking at what they say they do, and observing whether they actually do it. Secondly, we can develop intermediaries to do that. I think that, at the moment, intermediaries are in the main not being terribly helpful in bringing about the kind of objectives we want. Intermediaries are playing the game of being obsessed with shortterm relative performance rankings. One of the positive developments in this area is the creation of NEST, and I think that people who bring to the industry and to business the kind of attitude that NEST has are capable of being more effective representatives of genuine shareholder interests than we have had up until now.

Q27 Ann McKechin: If people continue to ignore voluntary statements, how could the implementation of policing be firmed up to ensure that they abided by them? You have mentioned that you are not keen on simply having stark Government regulation, but surely the stock exchanges and other professional bodies have a part to play in terms of their own rules and regulations?

Professor Kay: We are not talking about the rules and regulations of the stock exchange very much. We are largely talking about the people whom I see as being key to this process, who are asset managers, and developing different kinds of relationships between asset managers and the savers or the representatives of the savers—who are the ultimate beneficiaries—and companies. You will notice that the way I am describing it is a way that downplays the role of the stock exchange and public markets. That is quite intentional. What I would like to do—and this is fundamentally what is underlying the whole direction of the recommendations—is to try to move towards a world in which financial intermediation is based much more on trust relationships, and much less on transactions and trading, than has been true in the past.

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We will only be able to develop a structure that gets the capital that British business needs, and the returns that savers and all of us need to pay our pensions from, if we do that.

Q28 Ann McKechin: What is the push towards that? We say this is what we would like to happen. If it does not happen, what do you think we should then try to do?

Professor Kay: The biggest push to it would be if we—both as individual savers and as people like pension fund trustees who are placing funds with asset managers—began saying, “We are looking for longterm, strong, absolute returns from the funds that you invest, and are not very interested in your performance relative to other people.”

Q29 Ann McKechin: The pension fund managers are the key part, because the ability of individual shareholders is probably pretty limited.

Professor Kay: Yes, but the expectations of individual shareholders affect the attitudes of the asset managers and everyone else. At the moment, asset managers are very much concentrating on outperformance, relative to other asset managers. That outperformance is typically over quite short periods. That is the largest thing we need to fight against. We need to educate savers not to respond to advertisements that say, “Our fund beat 90% of the others over the last six months.” We need to enable trustees to feel that, not only are they not required to monitor the performance of their asset managers every three months, but that they are actually not serving their members very well if they do so. We need to tell pension fund trustees that the real approach they ought to be taking is finding managers whom they trust and in whose strategies they have confidence. We also need to be saying to asset managers, “This is what we think is good practice as an asset manager, and we are not only going to stop putting obstacles in the way of your constructive engagement with companies, but we are actually going to facilitate it.” There is a whole set of piecemeal changes. Some of them are regulations, but most of them are the attitudes that we need in order to get closer to where we want to be.

Q30 Chair: Can I just come on to investors’ forums, which is a concept that has been accepted by the Government. How do you think that the collective engagement of investors can bring about an alignment of the objectives of shareholders, investors, and business?

Professor Kay: This is what was just described in the last exchange—trying to offset what is described as the freerider problem. If by engagement you improve the performance of a company, but you own 3% of the company, you get 3% of the benefit from what it is you do. The more opportunity there is for people who collectively own 30%, 40% or 50% of the company to act together, the more offset we have against that particular freerider issue.

Q31 Chair: Some evidence that we have received actually challenges this, on the basis that it would “weaken the strength of the shareholder system,

namely, that shareholders vote and act as individuals.” How would you respond to that challenge?

Professor Kay: That is a good example of the issue, which I have described, of viewing markets through the eyes of market participants, rather than the interests of ultimate users. It is in the interests of everyone—savers taken as a whole and companies taken as a whole—that we should do as much as we can to encourage the better performance of British business.

Q32 Chair: Would it be fair to say that that view is based on a myth that shareholders do actually vote and act as individuals?

Professor Kay: They certainly do not vote and act as individuals, to some degree. Amongst the asset managers who control large voting blocks, there is some tendency for them to still act as individuals. It is not shareholders acting as individuals, but it is large institutions acting independently.

Q33 Chair: Consistent with what you said before, and looking at it through the eyes of the financial institutions, the pensions community has told us that this recommendation is not necessary, because “a significant amount of collaboration already takes place amongst UK investors” that is “not always visible.” What consultation did you have with investors, and what was the evidence that led you to come to these conclusions?

Professor Kay: I talked a great deal about this to large asset managers. As I described earlier, I think it is the case that there is a degree of coordination and consultation between Britishbased institutions. I described my experience, which was that Americanbased firms were more reluctant to be involved in this process than Britishbased firms, and their role in the process is now much larger than it was. People talk to me almost endlessly about concert party rules. Although the Takeover Panel kept telling us that this was not, in fact, an obstacle to collective action, it was perceived as one by many of these firms. The sovereign wealth funds, whom I mentioned, keep their heads down, in the main. It is certainly true that there was more collective action amongst British institutions 20 years ago than there is now, and that is primarily because British institutions were a larger part of the total market 20 years ago than they are now.

Q34 Chair: As I said before, the recommendation has been accepted by the Government. However, the quote is that the Government would “like to see further progress across the investment industry”. Who have you recommended should monitor progress in this area, and what do you think is the reason for the delay?

Professor Kay: Monitoring the process, and monitoring progress on most of the recommendations here, is very much a matter for Government. That is who should be monitoring this. I am not myself party to the discussions about setting up such a forum. That is not my job.

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Q35 Chair: We will no doubt be talking to Ministers about this at some time. FairPensions argues that, to shift incentives for market players, some kind of external force is necessary. We do not seem to be getting very far at the moment. There is buckpassing. What do you think this external force should be? Do you think it might be applied to either the Government or the regulator?

Professor Kay: The application of external force is clearly a matter for Government. We have talked earlier about the two ways in which that kind of Government external force can be applied. One is through Government setting the tone and terms of debate, and that is very important. The whole set of issues around saying that the purpose of finance is not to serve finance, but rather to serve savers and business, represents a big change from the tone of what Government has been saying about the financial system for quite some time.

The other is that we need to get regulation right. We are making some progress in that; there are signs that the new regime will be more user-focused than the old FSA structure was. However, we have an awfully long way to move in that direction, and to emphasise that the critical feature of our regulation should be what it does for companies and savers, not what it does for people in the market. In Europe, which is the driver of quite a lot of our financial regulation now, we are very far from being in the kind of position that I have been describing.

Q36 Chair: I am a layperson. I have never been involved in this particular industry at all. However, I think that my perspective is probably shared by the public at large, which is that just a change in tone is not likely to realise a change in habit, policy, and so on. Surely there needs to be something that will exercise more influence on the industry?

Professor Kay: I understand your desire, which, in large part, I share. If I could find regulatory provisions that would do the kind of job that we are describing, I would support them. I find it very difficult to see what these regulatory provisions are going to be. Indeed, the starting point should be withdrawing some of the regulatory provisions that are going in the opposite direction. We have, at the moment, a market abuse directive. Think about that phrase for a moment. It is not market abuse that we should be concerned with; it is customer abuse, and a customer abuse directive would look very different from a market abuse directive. Our concern is not with manipulating the market, except insofar as manipulating the market creates a worse deal for companies and savers. That is the kind of preoccupation we need.

I was quite struck, hearing an interview with the chief executive of one of the big execution-only share dealers acting for retail customers in the markets. He was asked what effect MiFID—the Markets in Financial Instruments Directive—had had on his customers. There was a pregnant pause for a moment, at the end of which he said, “I can’t think of any.” We are proliferating this kind of regulation, which essentially entrenches the existing structure of the industry. That is why I want to be focusing on the interests of users and customers.

Chair: We will look at that in greater detail during the course of the inquiry.

Q37 Rebecca Harris: You recommend that companies should consult their major longterm investors over major board appointments. I was wondering if you could just clarify for the Committee what you mean by a “major investor”, and also a “longterm investor”?

Professor Kay: We are really talking about, in general, the six to 10 large asset managers who are now speaking for a very large proportion of UK equities. Obviously, since they do not all hold the same proportions, they would be different people in relation to different companies. If we move to a world—which is the world I would like to see—in which there was more differentiation of asset manager portfolios than there is at the moment, so that you were not always finding the same six or 10 at the top of the shareholder register of companies, you would have much more specialist relations between companies and their investors. In that world, it would be natural and part of the ongoing engagement with the company that the company should consult the investor. That is what I have in mind. Obviously, companies cannot realistically consult shareholders at large. We have the essentially formal reelection at the annual general meetings that are part of current practice, but that is a formality, as we all know.

Q38 Rebecca Harris: Can you also define for us what you would consider to be a “major board appointment”?

Professor Kay: I think that, by “major board appointment”, I probably mean any board appointment. We were thinking, in part, that for smaller companies it would probably be primarily about the chairman and chief executive.

Q39 Rebecca Harris: So it would depend on the company, rather than the board. How would you recommend that companies should balance consulting with their shareholders with the difficulty of confidentiality around information attached to the appointment?

Professor Kay: This goes back to the regulatory front. I would like to be much more relaxed about all of this. I am not sure that the raft of regulations that we have designed to control the flow of information to investors is actually serving the interests of either investors or companies. It is in large part there to protect the interests of shortterm traders, so I am not that bothered about confidentiality. The sense in which I have to be bothered about the confidentiality front is that, at the moment, there are asset managers who will say that they are reluctant to be consulted by the companies on serious issues because that may make them insiders who are unable to deal in the company’s stock. That goes back to the issue that I am not really sure that the current, nearobsessive emphasis on uniformity of information is serving useful, desirable purposes.

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Q40 Rebecca Harris: Did you go as far as considering that longterm substantial shareholders should have direct board representation?

Professor Kay: That is a matter between the investor and the company. At the moment, many asset managers would say that they did not really have the expertise to do this. I would hope, increasingly, that they would. That is probably more a matter for smaller companies, where the company has more difficulty finding nonexecutive directors with wide experience, than it is for larger companies. A particular asset manager would ideally have quite a strong relationship with such a company, if he decided to invest in one.

Q41 Rebecca Harris: You recommended that BIS should take a rather more sceptical attitude about the claimed benefits of foreign takeovers. I wondered how much we have to be careful there, given that many UK companies are also active in acquiring foreign businesses. I wondered if you could comment on that.

Professor Kay: One of my views on this is that we have too much merger and acquisition activity of all kinds, whether inward or outward. I understand the concerns about the inward takeover—the Cadbury issue—but in terms of terrible takeovers that have damaged British business in the last 20 years, RBS taking over ABN AMRO or GEC taking over rather curious US telecoms companies were not great successes. The damage done to British business by M and A activity is not just a matter of good British companies being taken over, although that is a problem; it is also British companies who, when you talk to them about strategy—and this is true when you talk to a lot of people in the City about what they mean by “strategies”—believe it means, “What businesses are you going to buy and sell?” That is not what I mean by strategy. It may sometimes be the right thing to do, but strategy is really about building up capabilities and operating businesses. That is the focus that I would like to see.

Q42 Rebecca Harris: So therefore, future success in this area for you would be fewer mergers and acquisitions, or fewer that fail?

Professor Kay: I think we can all vote for fewer that fail. Since, to be honest, none of us know which are going to be successful or unsuccessful, I would like for there to just be fewer. One of the things that one is bound to think about is whether we should have more powers for the Secretary of State, or the Competition Commission or its successors, to block mergers. I am stuck there with the difficulty that either the Secretary of State or the company itself has in knowing whether a merger will succeed or not, in the long run.

Q43 Rebecca Harris: How does that work? As we have said, we do not know which are going to succeed and which are going to fail.

Professor Kay: I know that there are too many, but I do not know which ones are the “too many”. I would like to just have fewer. The real thing that we are trying to achieve is what I described earlier: persuading the senior executives that their job is to

develop the capabilities of underlying businesses. They are not what I have described as “meta fund managers”, who are juggling portfolios of businesses, rather in the way that fund managers are juggling portfolio stocks. That, frankly, is more or less how quite a lot of people have seen the chief executive role over the last decade or two.

Q44 Rebecca Harris: It is kind of a cultural change, basically, isn't it?

Professor Kay: Yes, and it is another good example of the kind of thing where it is very difficult to see how it could be addressed through regulation, but where we can do an awful lot by tone.

Q45 Rebecca Harris: There have been comments about the Takeover Panel; there have some criticisms, saying that it is effectively a cartel of the investment banks with no statutory basis, which focuses solely and explicitly on price. What kind of role do you see for the Takeover Panel in implementing your recommendations, and how would it perhaps need to change?

Professor Kay: I am not sure that I want the Takeover Panel to be doing very different things from what it is doing now. When there is a contested bid, there is a job to be done in insuring against malpractice of various kinds. That is what the Takeover Panel has done over the decades it has been in existence, and it has done reasonably well, overall. However, it is a terribly limited function, and of course it is not its function—nor should it be—to say whether a bid is any good or not. It has been described as a cartel of investment banks. I think that is largely right, although not necessarily derogatory, if it has the narrow role that I am describing. However, there is an interest on the part of investment banks. We have had a relatively modest rate of takeover activity since the crisis of 2007–2008. That is probably a good thing, but I am not sure that it is here forever. There are fashions and cycles in merger and acquisition activity, and I expect that we will have another one some time in the next few years.

Chair: Can I bring in Robin Walker on Cadbury, derivatives, futures and shortselling?

Q46 Mr Walker: Before we move on to that, I just wanted to pick up on a couple of points relating to foreign takeovers in my personal experience. I should probably refer to the register of interests the fact that, prior to coming here, I used to work in financial communications in the City. I actually worked on a number of takeover defences, both hostile and friendly, of UK PLCs. In my experience, when an approach was first made, in every case management set out to continue running the company, to defend the company, and to drive up the value of the company. However, there was then a process in which they drove up the value of the company, showed what a good job they were doing and won shareholders over, and then the shareholders ended up putting pressure on the management to sell at a higher price. In, I think, five out of the six of those types of situations that I worked in, the companies ended up being taken over. It comes back to this thing about the culture change

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of shareholders. Are shareholders just too ready to take cash when it is offered, and what can be done to make them appreciate the longterm value that can be created if they hold on?

Professor Kay: The most constructive thing that we can do is divert attention away from shortterm performance. If you are being judged by your relative performance over a threemonth period, and you are being offered a substantial premium for your shares over what they were selling at three months ago, the pressures to accept are really quite great. It is once you get into the business of looking at the portfolio over three or five years that it starts to be less obviously attractive to accept the kind of bids you describe.

Q47 Mr Walker: One of the problems there—and this comes into the whole CadburyKraft thing and the argument about shortselling and shortterm shareholders—is that not everyone holds their shares for five or six years. You have got the longterm investors, who are there and who form a rump, but often during the course of the takeover you will have more and more shortterm investors—hedge funds—moving in and taking a greater proportion of the register.

Professor Kay: As you know, one of the things that was put to us—and there was quite a lot of discussion about this—was whether shortterm holders of that kind should be disenfranchised in some way in these cases. It seemed to me that one reason for not going down that route was that if you asked, “Where did the arbitrageurs get their shares from?” the answer was, in most cases, “From the long-term holders.” That suggests that the real issue we have to address relates to the longterm holders, rather than to the arbitrageurs.

Q48 Mr Walker: The CadburyKraft situation was described at the time as a disaster for Cadbury and the country by interested parties. Traditionally, only 5% of the stock of Cadbury was held by shortterm owners. At the time of the sale, the figure had risen to 30%. I suppose it comes to that question: why should those short-term holders not have their influence reduced—although not necessarily disenfranchised—in a situation such as that?

Professor Kay: I do not see any harm in that. However, if, as we are saying, that 25% came from these longterm holders taking the higher price in the market, then that is the source of the problem. We would not change the outcome significantly. We might change it a bit, because some of these holders might be more reluctant to be publicly identified with growing their 8% stake, but it would, in a sense, be marginal.

Q49 Mr Walker: Overall, if all your recommendations were adopted by the industry and the Government, do you think there would have been any difference in the outcome of something like the Cadbury takeover attempt?

Professor Kay: We might just start with Government being less relaxed than it historically has been about takeovers in general. If one looks at examples of takeovers that one really does wish in retrospect had

been stopped, the examples would be the Ferrovial bid for BAA in terms of inward takeovers and the RBS bid for ABN AMRO in terms of outward takeovers. Powers already existed to stop these bids; they were just not actually used. In terms of generally reducing the incidence of these, we should just move away from where we have historically been, namely having more or less the most liberal regime in the world in terms of attitudes to takeovers of, or by, British companies.

Q50 Mr Walker: Going back to my previous experience, one of the nonUK situations that I worked on was the defence of Arcelor against Mittal. That was one in which Governments tried to play quite a substantial role in stopping the company getting taken over, but that eventually got effectively brushed aside by shareholder power and by the weight of hedge funds pushing for a deal. I suppose that there are limitations on what Governments can do.

Professor Kay: There are limitations. If we have a policy objective of reducing the pace of takeover activity, which is certainly one that I would like to have—as I said a few moments ago, it has happened of its own accord for the moment, but one might ask how permanent that is going to be—we can gradually ratchet up the degree of hostility to see what level is necessary to get, at least in that sense, a level playing field with other countries. One of the problems that we have is that there is a sense in the investment banking community that Britain is for sale, which is not true in the same way in many other countries.

Q51 Mr Walker: One thing that other countries are looking at, and that was not touched on in great detail in the report, was the impact of derivatives and futures and practices such as shortselling. Do you think that there is anything that we should be looking at in that respect?

Professor Kay: Quite a lot was said to us about shortselling. I came to the view that, while it could be the case that you had good companies that were being destroyed by shortsellers, one could not find examples of that happening, certainly not in Britain. However, one could find cases where bad companies, whose management either did not know or were not telling the truth about how bad the company was, had their company management damaged by shortsellers and were in some cases brought down by them. That kind of shortselling does not seem undesirable to me. It could rise to a degree at which it was undesirable, but I am not sure that we are there yet.

Q52 Mr Walker: That is interesting. You say firstly that shortselling is incompatible with the concept of stewardship, but you then go on to set out your reasons for defending it. How far do you think your recommendation that income from stock lending should be disclosed and rebated to investors would go to address the public distrust and concern about shortselling?

Professor Kay: I do not think it would address the public distrust of shortselling. One can understand the public suspicion of shortselling, because it is not a very nice activity, fundamentally. I think the rebate

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and disclose activity is just a matter of straightforward transparency about what the costs and charges of financial intermediation actually are. What we have at the moment is a situation in which some of these costs are, in effect, being concealed from the beneficiaries. Beneficiaries are potentially being exposed to risks that they may not know about, and the rewards relating to the risks are actually being taken by other people, rather than by the beneficiaries. I do not think that situation is acceptable.

Q53 Mr Walker: Speaking of intermediaries and beneficiaries, I just want to come back to your exchange with Ann earlier, where you were talking about the culture and attitudes of shareholders, and trying to change the culture in order to take a long-term approach. Intermediaries came up. One observation that I would make is that the biggest culture change of all has been in the intermediaries. Even during my relatively brief time in the City, I saw gradual decline of long-term corporate broking relationships, and of corporate broking houses that had based their whole approach on having long-term relationships with their clients. These have been replaced by a much more M and A, investment banking-focused approach. Do you think that there is anything that could be done to change that, and to reverse that direction of travel? From what I can see, that process is very much continuing.

Professor Kay: For me, that absolutely gets to the heart of the issue, that the largest cause of almost all the issues that we are describing has been the replacement in financial intermediation of a relationship-based culture with a transactions and trading-based one. How do we reverse that? To repeat the kind of approach that I have been saying over and over again, firstly it is a matter of tone and culture. We can do a lot to set the tone. The tone has almost been that the relationship-based way of doing business in this sector is a terrible, old-fashioned way of doing things that the benighted Germans are still immersed in, but that we Brits and Americans have got over. Instead, we need to be moving in the opposite direction and confronting the reality, which is that the Germans have actually done pretty well in building great companies for the long term.

There is the tone issue, and then there is the regulatory issue. As I have suggested at several points, regulation has in large part been about making life safer for traders. What we ought to be doing is not making life safer for traders, but rather making life easier for long-term investors. That is a very big change of philosophy.

Q54 Chair: Before I move on to fiduciary duty, could I just go back again to the Cadbury-Kraft situation? In response to Robin's question, you pointed out—quite accurately, I believe—that it was actually the long-term investors in Cadbury that eventually agreed to sell. I cannot remember the exact figure, but the majority of the shareholding certainly would have been composed of long-term investors. However, would it not be true to say that it was the activities of the short-term investors that drove the share price up to a point that the long-term investors were prepared to sell at, and if

those short-term investors had been disenfranchised, that would have been unlikely to happen?

Professor Kay: I am not sure that is right. What drove the price up was how much Kraft was, in the end, willing to pay to get it. I do not see that the role of the hedge funds played a large part in that.

Q55 Chair: So you don't think that was a significant factor in the eventual share price at which it was sold?

Professor Kay: No. I think that the board pushed to the limits of Kraft's willingness to pay.

Q56 Chair: Can I come on to the fiduciary duty issue? What do you consider to be the minimum fiduciary standards that a regulator should enforce?

Professor Kay: The minimum is that anyone who is engaged, either in advice or in discretionary activity of some kind, accepts the obligation to put the client's interests first, ahead of his or her own. The second is that conflicts of interest should be avoided, and should be disclosed where they are not avoided. There should be a requirement not to profit as a result of the existence of the conflict of interest. I think that these are the minimum standards, and in my view, I do not want to distinguish between wholesale and retail markets in the application of these.

Q57 Chair: That is an interesting reply. I was under the impression that you had highlighted loyalty and prudence as being core fiduciary duties, but you have not actually mentioned those, at least not directly. Why is that?

Professor Kay: Loyalty and prudence are the core fiduciary principles. I was translating them into specifics for the purposes of financial services regulation, but it is loyalty and prudence that lead you to these principles. Loyalty means putting the client's interest first, and prudence, which relates to both clients' interest and conflict, is essentially about doing what you would do yourself if you were in the position of the client.

Q58 Chair: You recommended that the Law Commission be asked to review the legal concept of fiduciary duty, which has been accepted. What do you think the key areas of focus should be, and why?

Professor Kay: There are two parts to the issues on fiduciary duty. The part that we have just been talking about is whether the FSA's or its successor's rulebooks correspond to standards of fiduciary duty. To my mind, they have historically fallen significantly below these kinds of standards. It seems to me that imposing these kinds of standards is essential to the creation of the trust relationships that we have all talked about. Then there is a specific problem of fiduciary duty in relation to pension fund trustees and similar trusteeships. I think you will all have received material from FairPensions, who have particularly developed that issue. It is apparent that there is legal advice around that interprets fiduciary duty in an extremely restrictive and narrow way.

What I discovered in discussion with lawyers in the course of the review was that many lawyers took the view that that restrictive interpretation is not a correct statement of the law. However, it seemed to me that

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that was something that ought to be discussed and resolved in order to clarify what fiduciary duty was. As a matter of fact, in a personal sense, I have a role as trustee in relation to managing the affairs of my Oxford college, and I thought I knew what my obligations in respect of that were when I began the review. I have found myself much less clear at the end than at the beginning. I do not think that is a very satisfactory situation.

Q59 Chair: You have done an awful lot of analysis and consultation on this. Why have you delegated it to the Law Commission, rather than make a recommendation yourself?

Professor Kay: I have spelled out where I would like to be. What I think we ought to have in terms of pension fund trustee obligations is, really, what we talked about earlier. You ought to be required to do what you yourself would do if you were in the shoes of the beneficiaries. That, it seems to me, means that you do not have to behave monstrously and unethically in order to make more money for your beneficiaries, which—to caricature a bit—is one suggestion of how the law is interpreted. Equally, you may not pursue your own particular moral, ethical or political purposes with the beneficiaries' money. We want to define the middle ground between the two: that is, that the morality and ethics that you apply should essentially be those that would be appropriate to the beneficiary.

Q60 Rebecca Harris: One of your recommendations was that asset managers should fully disclose costs, whether estimated or actual transaction costs, and performance fees charged. How disappointed are you that the Government has not decided to make this compulsory?

Professor Kay: That is one of the areas in which I think we should have regulation that could be effective in doing this.

Q61 Rebecca Harris: So when it comes to the Government bringing its progress report forward, you would like to see that there has been substantial progress in this area.

Professor Kay: Yes, on proper disclosure of charges and costs of asset managers, because we don't really know in aggregate what they are.

Q62 Rebecca Harris: How detrimental do you think it is that we don't have this now? How much damage does that do?

Professor Kay: If people knew how much they were paying for intermediary services at the moment, there would be significantly more effective pressure to get that done. There is quite a lot of damage.

Q63 Ann McKechin: Could we just turn to this issue about reporting by companies? You say that much of the information is simply noise. Some people might argue that one person's noise is another person's data. What, in your mind, is too much information, or is it badly presented information that is at the core?

Professor Kay: It is a bit of each. If you look at the report and accounts of large financial institutions like

banks or insurance companies, you get hundreds of pages, and you don't learn very much, even if you go through the hundreds of pages. What is the answer to that? We could make it thousands of pages. Perhaps, to some degree, we should, but I think that if it moves to thousands of pages it will be all the more difficult to go through, and I am not sure that we will be that much better informed when we do it. So, where do we go? There are two directions. One, which is rather outside of my terms of reference—although it something about which I feel strongly—is that these institutions should be made a lot simpler than they currently are. The second is that there should be much more negotiation between users of accounts—the important ones, for our purposes today, are asset managers—and the companies that disclose them.

Q64 Ann McKechin: Do you think that there is a role for the investors' forums in this?

Professor Kay: That could be a positive one in relation to this. Also, the kind of information you need about a company is very much specific to the sector, and even to the company. What you need to know about a bank is rather different from what you need to know about a retailer, and so on. It goes back to this favouring of transactions and trading over relationships. What we have tried to do is to block the provision of information through the relationships and say that companies have to provide a standardised mass of information for everyone. That has created the world that we see, where we get lots and lots of information that is not terribly useful.

Q65 Ann McKechin: You made a clear recommendation about quarterly reporting obligations, and the Government has supported your recommendation. Some people might argue, "How can less information be better?" Is it simply just that you are trying to change behaviour, rather than trying to block information coming out at a particular time?

Professor Kay: The argument that says that more information is always better is tempting, except that we all know that it really is not true. It is very difficult to ignore information, even if it is essentially irrelevant.

Q66 Ann McKechin: The problem is the way it is used, rather than the information itself.

Professor Kay: Yes, and that it is then manipulated. That has been part of the problem with quarterly reporting, which has reached extremes in the US. Companies produce steady streams of reported quarterly earnings. In many cases, they produce steady streams of these quarterly increases, until one quarter they do not because reality has finally broken through. It really has been part of a process of earnings guidance, earnings management: a kind of dysfunctional cycle of relationships between analysts and companies. I think we would like to just get rid of that cycle and have it replaced by, typically, more qualitative relationships between the company and the asset manager.

Q67 Ann McKechin: We are moving away from the crack cocaine of quarterly reporting, and you have

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talked about highquality, succinct narratives. How would you define such a narrative?

Professor Kay: That is difficult. We can invoke certain elements of common sense and audit in this. What we want to avoid, obviously—and what it is very easy to see that we might get—is long narrative reports that are written by PR consultants, which are statements of motherhood and apple pie that do not get into anything substantive about the company. It is quite hard to set a rule saying that what you write has to be substantive.

Ann McKechin: “Avoid the flannel and get to the facts.”

Professor Kay: We would probably transform Parliament, as well, if there was a “no flannel” rule.

Q68 Ann McKechin: Presumably, perhaps, codes of practice should try to give some indication to people about how good reporting could actually be achieved?

Professor Kay: Yes. There is a role, as I have described, for the auditors, and there is a role for an asset manager of a large company, who can say, “This stuff is just not good enough.”

Q69 Paul Blomfield: Clearly, the issue of levels of corporate pay is an issue on which there is lots of public focus. I was actually interested that, although you looked at the structure of pay, you did not feel tempted to comment on the levels of pay.

Professor Kay: I certainly felt tempted to comment, but since there was another BIS exercise looking at levels of pay while I was doing this piece of work, I was encouraged in the view that it was not my business. I received further encouragement from being told, especially at the interim report stage, that if I wrote about levels of executive remuneration, nobody would take any interest in anything else I said.

Q70 Paul Blomfield: I understand that entirely. I guess there might have been wider public interest, and I am reading into what you are saying that you would share the wider public concern about the excesses of corporate pay and their impact.

Professor Kay: Both the structure and the levels of executive remuneration are wrong, yes.

Q71 Paul Blomfield: You did then talk about—in terms of structure—linking more to long-term performance, but you also acknowledged in your report that that was what most companies said they were doing anyway.

Professor Kay: They said they were doing that, but a threeyear longterm incentive plan does not seem to me longterm, in terms of building great British businesses.

Q72 Paul Blomfield: So recognising that, you then came out, trying to move things forward, with the specific recommendation that incentives should only be provided in the form of company shares to be held at least until after the executive had retired. Were you then disappointed by the Government response, which just said that the structure of remuneration should be determined by individual companies in consultation

with their shareholders? That does not move things forward at all.

Professor Kay: It does not move things forward anything like enough. As I indicated earlier in the discussion, I think that the pursuit of particularly elaborate bonus schemes for executives has just been a serious mistake. It has been damaging, both to individual companies and to public perceptions of business. What I want to see is people running large British companies whose primary motivation is that they want to build great British businesses.

Q73 Paul Blomfield: As such, the Government response really fails to address one of your most substantive recommendations. I wonder, therefore, whether you felt that that recommendation should be made compulsory, notwithstanding your antipathy to regulation. In your report, you develop a very effective critique of selfserving circles of remuneration consultants. I am also minded of the report in the last few days, regarding the way that the chair of the remuneration committee of Barclays was heavily disregarded by the chairman of the bank when she made recommendations on remuneration there. Therefore, have things got to the stage at which we need to look at your recommendation being made compulsory?

Professor Kay: I think that there is an argument for that.

Q74 Chair: We are nearing the end now. I just had one or two questions. The first is relevant to long-term thinking. Aviva provided us with evidence that the average holding period for UK equities had fallen from eight years in the 1960s to just seven and a half months in 2007. Do you think that there is a case for reconsidering a financial transactions tax, not so much to raise revenue, but potentially to reverse this trend?

Professor Kay: Yes, there is. If we could have a financial transactions tax that worked, it would seem to me to be a very attractive way of discouraging that trading activity in favour of longterm investment. It is clearly very difficult to structure a financial transactions tax that works, and I have two large worries about this. One is that I have observed the financial transactions tax that we have at the moment, which, far from discouraging trading, is actually solely a tax on longterm investors. Someone described it to me as a tax on UK pension funds and private individuals, and that is essentially what it is. We have been very unsuccessful so far.

There are clearly a lot of things that, if we introduce a simple financial transactions tax here, could be done to avoid it. The danger is that we simply shift a great deal of equity trading into other—possibly less regulated and probably offshore—forms, and into more complicated instruments of various kinds. We have to be reasonably sure that we can structure a tax that will not do more harm than good, but if we could, I would support it.

Q75 Chair: That is an interesting response. You are an expert in this area; could you do it? I am not trying to give you a job; I am just interested to know.

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Professor Kay: I have, and I have discussed with other people, ideas about how one might structure this. It is genuinely quite hard. There only have to be a few large loopholes—I am going to mix my metaphors—and people will drive a coach and horses through them. We know, for example, that a very large amount of shortterm trading in UK equities already takes the form of contracts for difference, rather than direct purchase in sale of shares. We can do things about that, but then we have to look at things that would be done to evade or avoid the impact of that. It is complicated. I am not sure that it is impossible, but it is not easy.

Q76 Chair: That is interesting, and we may want to pursue that a little further with other speakers. Could I move on to highfrequency trading? You did not make any recommendations about this. Why not?

Professor Kay: There were two reasons. One was that there was another BIS exercise on highfrequency trading being conducted at the time. The other was that, although the existence of highfrequency trading is not something that one could say is very supportive of longterm decision making in British business, I concluded quite quickly that it is not the principal issue and problem, which is to do with the behaviour of the longterm holders. You quoted the Aviva figure for the average holding period. Of course, that is greatly affected by large amounts of very shortterm trading, but it is not surprising when you think about it. If you look at the numbers, although much of the turnover is accounted for by very shortterm traders, that does not mean that very shortterm traders own a very large proportion of British business. They do not. Most shares are actually held by rather longerterm investors, so that leads one to the perspective that the issue that we need to tackle is getting the incentives and approaches of the longterm investors right.

Q77 Chair: I will accept what you say as being probably correct. However, it is equally true that it has precipitated stock market volatility in some countries. I believe that the German Government intends to introduce a law to clamp down on it, because of this market turbulence. Do you think that is the right approach?

Professor Kay: It goes back to the discussion that we have just had about a financial transactions tax. It might be a good idea if you could introduce something that you were confident would work. I rather fear that, if the German Government introduced it, it would just mean that trading would not take place in the environments where the German Government's jurisdiction ran.

Q78 Chair: So do you think that it might help the British environment?

Professor Kay: Possibly, but I think that we should not feel very proud of that.

Q79 Chair: Could I just go back again to the Cadbury situation? As a West Midlands MP, it is obviously a little bit of a preoccupation of mine. Earlier, I asked you about the role of short-term investors in the company, and you said that basically the final share price was determined by the commitment of Kraft to pay that. That probably is the case. Do you think, therefore, that shortterm investment or speculation on this scale is irrelevant to mergers and acquisitions in this country?

Professor Kay: I do not think it is irrelevant, because you made a point a moment ago about the volatility of markets. One of the effects of a rise in the volume of trading across financial services has been to create greater market volatility. Merger and acquisition activity is in part a function of market volatility. It creates more opportunity, and that feeds back on itself.

Q80 Chair: Do you think that there is a case for disenfranchising shortterm investors of the nature that invested in Cadbury?

Professor Kay: When I talked about shortterm investors there, I meant shortterm investors in a much broader sense. As we were describing, I do not think that the result in the KraftCadbury case was basically fixed by the existence of arbitrageurs and other shortterm investors.

Q81 Chair: I accept that, but do you think there is a case? Would it impact on the level of mergers and acquisitions activity?

Professor Kay: If there was less short-term trading, I think it would.

Q82 Chair: That is interesting. Could I just conclude with another one? One of the policies that has been introduced, and is proving slightly controversial, is the 28day "put up or shut up" conditions that arose very much out of the Cadbury situation. Have you any views on that?

Professor Kay: From what I have said earlier, you will see that almost anything that puts a bit more sand in the wheels of the merger and acquisition machine is something that I would welcome.

Chair: On that note, can I thank you for your contribution? It is a very useful opening. Obviously, we will be talking to a whole range of representatives from the industry, Government, and lobbyists on this, and we will come to our conclusions in due course. At the moment, can I just thank you for your contribution? It is a very helpful start to this particular review process.

Professor Kay: Good. I am glad that I have provoked your interest.

Thursday 14 February 2013

Members present:

Mr Adrian Bailey (Chair)

Paul Blomfield
Rebecca Harris

Ann McKechin
Mr Robin Walker

Examination of Witness

*Witness: Lord Myners CBE, Former Financial Services Secretary and author of *Institutional Investment in the United Kingdom: A Review*, gave evidence.*

Q83 Chair: We are slightly early, but I see no reason why we should not start. Can I thank you and welcome you? Obviously, you have a unique insight into this particular issue, and we would welcome the opportunity of questioning you on it. I understand that you would like to make a short opening statement, so I will invite you to do so now.

Lord Myners: Thank you, Mr Chairman and members of the Committee, for inviting me to give evidence. By way of disclosure, I am a director of three investment funds and three public companies. It is a pleasure to be here in the Wilson Committee Room on the 50th anniversary, to the day, of Harold Wilson becoming Prime Minister for the first time.

I have spent 20 years in the investment management industry, most of them as a CEO of an investment company in the City. I have also been a director of a sovereign wealth fund. I spent a dozen years as a corporate director of companies, including Charing Marks & Spencer and Land Securities, the largest quoted real estate company in Europe. As such, I have seen the issues covered by Professor Kay from the perspective of both the institutional investor and the company director, and also from the perspective of being a trustee of pension schemes.

I have done five reviews for Government on issues relating to ownership and stewardship. I did two for the Department of Trade and Industry during the previous Conservative government. The broad thrust of those was evidenced in their titles: one was called *Developing a Winning Partnership*, and the other was called *Creating Quality Dialogue*. They focussed on this space between companies and their owners, or their surrogate owners. I also produced three reports for the Treasury: one on institutional investment in 2000–01, another on the governance of mutuals, and a third one on the financing of high-tech companies.

Professor Kay has produced for us an academic treatise, which is very well argued. It identifies the core issue, which is the emergence over the last 30 years of a transactional relationship between companies, investors and intermediaries, and the dominance of the financial intermediaries, matched by a steady erosion of trust as the basis for commercial relationships. Essentially, we have seen the adoption of an “eat what you kill” culture in the City, as opposed to a culture in which one behaves more as a GP would towards a patient.

However, the Professor fails to come up with many practical proposals beyond wishful thinking. I sense that he lost heart towards the end. He was worn down by the weight of institutional lobbying, and we can

see similar evidence of that in the response from the Secretary of State. I do not think that the Professor’s report will add a jot or tittle to the prosperity of the UK economy and the success of our businesses. If the test is whether, in 2022, we will look back and say, “10 years ago in the UK we had the Kay Review report, and everything changed,” I think that test will most assuredly fail.

Kay offers no route to reversing the decline in the relative expenditure in the UK economy on research and development, or the decline in the commitment of fixed capital in support of employees. There is nothing in the Professor’s report that will end the dominance of markets over users; there is nothing in the Professor’s report that offers the prospect of the stock exchange becoming a primary source of new capital, as opposed to a secondary trading market; and there is nothing in the Professor’s report that seriously challenges the value and job destruction associated with reckless merger and acquisition activity.

The Professor barely penetrates the carapace. In some places, he is contradictory. He wants less intermediation, and yet he proposes a new intermediation body. The Professor faces both ways on short trading, as Mr Walker exposed in his cross-examination. There is a lack of consistency. In other areas, the Professor simply misunderstands the issues. When discussing stock lending, he fails to understand that these are not lending transactions: rather, these are re-purchase transactions. He focuses on reward, and almost completely ignores risk.

In other areas, the Professor’s recommendations are irrelevant. The recommendation on risk modelling is one that both the Secretary of State and the industry have almost completely failed to understand. I cannot work out what he is really getting at. The Professor also gives up in other areas: we have a lot about M&A, containing an element of xenophobia, but in the end he comes up with absolutely nothing in terms of a tangible recommendation.

However, I reserve my greatest disappointment as far as the Professor’s report is concerned for his complete failure to follow up on some of the very best ideas originally floated in his interim report. We find nothing of any significance in his final report on the subject of taxation, or why a trading culture is promoted by tax exemption. We find nothing in his final report about a financial transaction tax, which would slow down the pace of hectic activity in the City that sees trading now timed in microseconds of ownership, rather than anything that represents the sort of vision the Professor would like us to believe in.

He says nothing about employee ownership. He does not build on the work of the Bullock Report, released 36 years ago: he completely ignores it. He says nothing about slowing down the speed of merger and acquisition activity. In fact, he endorses the Takeover Code changes that speed up takeover activity in an economy that already has the most permissive rules in the developed world for taking over companies. There is no other economy in the world where it is easier to acquire a company than in the United Kingdom.

Despite having mentioned it in his interim report, he says nothing about the stewardship model in Scandinavia. In this model, the institutional investors sit on the nominations committee. They choose the directors. They make sure the directors are truly accountable to the owners of the business, as opposed to the directors being appointed through a process that is largely dominated by the Chairman, and through a voting outcome that even the North Koreans would be embarrassed by. He says nothing about differential voting. He says nothing about repairing the flaws in the voting system.

He misses major areas of great significance and importance. Even more fundamentally, he does not ask what the purpose of a public company is. He says early on in his report that public listing is now not a major source of capital for investment, but he does not get deeper into the question of whether we have too many public companies. He does not ask whether it would make more sense if our institutional investors owned these companies as private businesses, owned perhaps by two or three pension funds, who were able to appoint their own directors. This is as opposed to them owning 2% or 3% of each company and taking little interest in how those companies are managed. If I may say, in promoting private ownership of companies, I am not promoting private equity. I am simply saying that large pension funds could own private companies. They do not need liquidity.

In closure, Chairman, the industry's response to Kay is, I think, one of considerable comfort. It might be summed up with: "Move along, Sir. Nothing much to look at here." There has been no disturbance or disruption to a highly remunerative business model. I doubt whether anybody who comes to give evidence to you will have much concern regarding Kay, other than, conceivably, the people from FairPensions.

I am nearly finished, Chairman. I know I am stretching your indulgence. I apologise for that, but I am trying to give a sense to the Committee of where I come from. I know it is important for you to read your own report into evidence that is given to you.

One area in which Kay approaches tangible recommendations, as opposed to wishful thinking, is that of a forum for investors. I have previously endorsed this concept myself. I have talked at length about ownerless corporations, and the need to create a better nexus. However, Mr Chairman, little progress has been made on establishing this forum. One or two people are trying; Daniel Godfrey, of the Investment Management Association, is one. However, what we will end up with is a forum that is dominated by trade associations, and trade associations' modus operandi—their purpose for existing—is to protect the status quo. It is not to change things. I think you will

find that, at best, this is run on a part-time basis. It will not have a fully paid secretariat. It will not have a significant budget. Sovereign wealth funds will stay well away. There may be some face-saving approach in which they are given associate or observer status, but they will have no interest in being part of this investment forum.

I will be one minute, Mr Chair, or less than one minute.

Chair: We would like to get some questions in.

Lord Myners: The Secretary of State should, in my view, have taken a much stronger line. He should have said, "I want to see this forum established." He should have invited two or three people to produce a short report over 30 days regarding what the options are, and he should have said that this can be financed out of the PTM levy, which is the £1 charge that appears on a contract note. This is used to pay the City institutions who staff the Takeover Panel, so this works well for the City institutions. Why can that not be used to pay for stewardship? Why can directed commissions not be used to pay for stewardship?

Likewise, on the issue of looking into the legal issues around fiduciaries, as far as I am aware, Mr Chairman, very little progress has been made with the Law Commission.

Chair: We will be asking questions on that.

Lord Myners: I think, sir, that we ultimately have a report where the reviewer and the Secretary of State have both been nobbled by existing interests. The British Horseracing Authority would probably order an investigation if they received a similar report that was so lacking in penetrating analysis or strong recommendations.

Q84 Chair: Thank you. I am not sure whether I would draw a parallel between this Committee and the British Horseracing Authority, but we will certainly be holding a similar sort of inquiry.

That is a pretty comprehensive opening statement. It may have anticipated some of the questions we intended to ask, but I think it is fair to say that it could generate further questions, which may or may not be picked up today. Once we have read the transcript of your opening statement, we may well write to you with some further points to be clarified. Your opening remarks are a pretty robust criticism of the Kay Report. You yourself made a report 10 years previously. In many ways, your approach was quite similar to Kay, in terms of commitment to the voluntary approach. What parallels would you draw between the two reports, and why are you so critical of Kay, given that there is not a great deal of difference in approach from your own, 10 years earlier?

Lord Myners: That, Chairman, is a very fair comment. The answer is that I am very disappointed in the lack of progress after my report on institutional investment in 2001. As you say, it relied on the same statements on principles of best practice that Kay is continuing to rely on. I have come to the conclusion that there are some fundamental flaws in our current approach to corporate ownership, in which most of our very large companies are owned by an extraordinary number of institutions, all of whom own

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a tiny percentage. None of these institutions feels empowered or obliged to act like a true economic owner. All of them, with a few noble exceptions, see selling as a better option than getting actively involved when they see a company failing to invest or perform well.

That is why I come back to the conclusion, Chairman, that what I have described as the “ownerless corporation” can only be successfully addressed if we see a fundamental change. There needs to be more concentrated ownership, and more activist shareholders who are properly equipped and empowered to become involved. Another important step in that respect would probably be for a smaller proportion of our economy to be in the hands of publicly listed companies.

A number of the areas that Kay picks up, such as the costs of transaction and the failure of investors to get actively involved, are ones that I have previously addressed. He seems to address them as though they are novel and have not previously been looked at. In fact, there is a long succession of reports on these areas, including that of the Wilson Committee, which I think was before the Bullock Committee. There is very little in Kay’s early chapters that represents any fresh and additional perspective on these issues.

Q85 Chair: One of the problems, as I see it, is that both you and Kay were pretty strong on analysis but both reports have been weak on providing a route map from the analysis to the objective that you would like to achieve. You talked about more concentrated ownership. How can you get more concentrated ownership without intervening in the market in a much more direct way?

Lord Myners: The answer here is, I think, the same one that I gave in 2001. The ultimate owners—in most cases the trustees of pension funds or endowments, or the directors of insurance companies—need to ask themselves whether this current model is working successfully from their perspective. Kay makes the point, from which I do not dissent, that the current model works very well for the agents. It works well for the fund managers and for all those who are giving advice, such as the consultants and other intermediaries. What we need here is a more fundamental review by asset owners regarding whether this model works.

As I said, my contention would be—and it is interesting that some of the sovereign wealth funds are moving in line with my contention—that they do not particularly want to invest in listed companies. They would rather invest in private companies, where they can exercise more control, or, importantly, they want to invest in companies that have anchor shareholders. These are strong, significant, long-term shareholders who are represented on the board of directors and who take a real interest in what the company is doing, rather than people who are just trading bits of paper. The problem is that our big companies are now owned by share traders. They are not owned by investors.

Q86 Chair: How can you proscribe that?

Lord Myners: I don’t think you can proscribe it with absolute confidence, Chairman. However, I do think that Kay is right on the issue of fiduciary duty. I think it would be beneficial to have a more serious set of statements about fiduciary duty, in which, for instance, the trustees were placed under an undoubted and undeniable obligation to properly account for how they align the way in which they invest with the best interests of members of the scheme.

Q87 Chair: I am going to ask some questions subsequently on fiduciary duty. If I can just come back, I believe you told the *FT* in 2011: “You can sum up my report in four words: a call for action.” That goes back to your report in 2001. The fact that we have had the Kay Report does demonstrate that that level of action has not actually been generated. It comes back to this core issue: how can you change a market that seems to work well for some, when they have such a strong vested interest in sustaining the model as it now is, irrespective of the economic benefit to the actual investors?

Lord Myners: I think my own report—which was a call for action, and primarily a call for action by asset owners—did have some impact. I think that the direction of travel was right. I am a naturally impatient individual, and therefore the speed and length of travel was not as great as I would have liked. One of the phrases I like in Kay’s report, Chairman, is about market abuse. He says the very fact that we call it “market abuse”, rather than “customer abuse”, tells us how our whole thinking—including the regulators’ thinking—demonstrates that we believe the market is our saviour here. The market is not our saviour. We have learned that markets are not as efficient as an economist might suggest. We know that markets lead to crowding, in terms of everybody moving in the same way. We know that a reliance on markets does not ensure safe outcomes for clients of financial services companies and investors. We need to reassert, or assert, the primary interest of the asset owner.

The problem is that most of the people who have contributed evidence to Kay, who are listed at the back of his report, are agents. They are people who say, “This system works very well for me. I don’t want to change this at all.” How, therefore, do we give voice, power and expression to the people through their savings and investment schemes? There are radical options, which I think Kay should have considered. He does not consider employee ownership at all. He does not ask whether it would be better if we found a system where, for instance, companies were required to put 0.5% of their new shares into an employee trust each year, until such point as the employee trust became the largest shareholder in the company. For most companies, Chair, it would take seven or eight years to get there if it was 0.5% per annum.

It would not take very long at all, and there would not be much dilution, but it would represent a fundamental change in the market. Kay does not consider anything as radical as that at all. He stays in these very narrow tramlines of conventional thinking, with nothing in his report that disturbs the City institutions.

Q88 Chair: I am sure those comments will be music to the ears of the employee-share ownership movement. Looking at the market, and trying to understand what has happened for us to get where we are at the moment, you reported in 1999 that only 15.3% of UK shares were held by individuals. Kay reports that in 2010 that figure had fallen to 11.5%. Why has this happened, do you think?

Lord Myners: Data around ownership is highly suspect, because of the way in which shares are registered through nominee companies. For instance, if a UK pension fund is managed by Fidelity, which is an American company with a UK office, is that registered as American ownership or British ownership?

One should treat the data with some caution, but the central thrust of the decline in individual ownership is undoubtedly correct. I would venture to suggest, Chair, that the financial services industry has been very successful in lobbying government to ensure that people are encouraged to invest through funds, rather than themselves. Funds have a tax-preferred status: if you invest yourself, you pay capital gains tax, but the fund does not pay capital gains tax. If you want tax protection through an ISA, you have to make it through a fund. If you want to invest in venture capital, you have got to do it through EIS or a VCT. The industry, at every point—whether on charges within funds, on disclosure, on tax enabling, or on regulatory restrictions—has consistently directed Government and Government policy towards the promotion of fund-based investment rather than individual investment.

Q89 Chair: That is an interesting point—that the industry has exercised pressure on the Government. There is a whole range of government saving schemes that would conform to the model to which you have just referred. You feel that has come from pressure from the industry, rather than from a Government approach to adopt the most risk-averse way of encouraging the public to save?

Lord Myners: Government may well have been persuaded—indeed, was undoubtedly persuaded—that it was an outcome that was risk-averse and in the customer interest. Government was equally persuaded that previous restrictions on maximum charges for unit trusts should be lifted, and of other things that suited the industry very well. What we know, Chairman, is that most unit trusts—90% over periods of more than five years—underperform the index. This is extraordinary. 90%—nine out of 10—professionally managed funds produce a worse return than you would get by throwing a dart 50 times into the back page of the FT and buying the shares where the dart penetrated the paper. Somehow, Government has been persuaded that this is a safe and good outcome for the customer, when the data might at minimum suggest it is not as simple and straightforward as suggested. However, it is an outcome that has suited the fund management and banking industry very well.

As you hear, Mr Chair, I am quite cynical. I have been in this industry for a long time. I was also, of course, a junior Minister—a very junior Minister—for 18

months in the previous Government. I had first-hand experience there of seeing how the financial services industry lobbies HMRC, the FSA, and the Treasury.

Q90 Chair: You spoke earlier about the difficulty of identifying the true ownership of UK shares. You can quibble about figures, but it does seem to me that there has been an increasing level of ownership based outside the UK. When you did your original report, did you anticipate that, and did you factor that into the recommendations that you made?

Lord Myners: No, I did not, Chair, but it was an extrapolation of a trend that has been in place for a long time. Of course, there is a reverse to this as well: more foreign institutions own a significant part of the UK quoted sector, but more UK institutions now have their money invested outside the UK, and there is a lot of academic evidence as to why it makes sense to diversify portfolios geographically. The consequence, as far as the Professor's report is concerned, is that generally speaking—one has to be careful about too much high-level generalisation, because there are commendable exceptions like BlackRock and Fidelity—overseas investors take less interest in issues of governance and ownership in their non-domestic markets.

This is also true of our institutional investors, who are much more focussed on the governance of UK companies than they are on the governance of Indonesian, American or Mexican companies in which they may have invested the savings of their British clients. This is a global trend, Chair. It cannot be reversed within the limitations of the public company model.

Q91 Chair: It is an interesting observation. On the basis of what you have said, with the increase in globalisation of share ownership, there is potentially a decrease in quality governance throughout the world.

Lord Myners: Yes.

Chair: It is difficult enough to get action in this country, but do you think that there is a case for trying to get some sort of international model?

Lord Myners: I will be very interested, Chair, to read the transcript from when you interview people who are supposedly establishing this investor forum, and to see how successful they are in convincing you that they are going to set up something that is really meaningful. My suspicion is that you will have significant doubt. I would then suggest to you that, if they cannot do it alone in this company, it is going to be almost impossible to do it globally.

If I may briefly add another point here, Chair, I am less concerned about the internationalisation of ownership than I am about the agglomeration of ownership in the hands of a small number of very large investment institutions. The problem we have here is that a large institution might own 5% of a company's capital. Therefore, for the company, this institution is very important. They are the largest shareholder: they own 5%, and the company will want to have an active dialogue. However, for the large institution, it might be an infinitesimal amount of their total assets under management.

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The company will want a close engagement, and Kay talks about the appointment of directors and these sorts of things. Although the company wants and expects that, the institution will have thousands, tens of thousands, or hundreds of thousands of these little investments. How can they possibly think and behave like true economic owners? That, Chair, is—I believe—the fundamental flaw here. We have come to believe that the public company model is a superior one, and it clearly is not. It is failing in terms of its primary economic purpose.

How can we fix it in the interim? There need to be more activist shareholders who take significant shareholdings, around 10% or 15%. They need to appoint people to the board, which means they need to be engineering that themselves in terms of the skills they need to do that, and they need to commit long term to be an anchor shareholder in that company and have the right skills to work in the board of directors. That is a radically different model from the one that we have at the moment, which I have characterised as the “ownerless corporation”, where nobody cares much about what happens in a company. If it looks like it is all going to go wrong, we simply sell our shares to somebody else and exit.

Q92 Ann McKechin: Good morning, Lord Myners.

Lord Myners: Good morning, Ms McKechin.

Ann McKechin: You talked in your own report, back in 2001, about the importance of attempting to seek an effective approach that does not rely on direct government intervention in banning or directly determining behaviour. Professor Kay recommended a fairly similar approach. However, this morning, you have mentioned a more activist shareholder base, and you have talked about employee share ownership. Presumably, you cannot actually achieve employee share ownership without a certain amount of compulsory regulation. In what way do you think that your original “comply or explain” principle did not work, and do you think that there is now an argument for greater compulsion?

Lord Myners: There are many things in my original report that I stand by. In particular, I stand by the importance of having trustees who are better qualified, more knowledgeable and more independent-minded, and who approach their responsibilities in a more business-like way. However, there are issues around the public company model that I see with greater clarity now than I did 10 years ago. I perhaps failed in that respect. There are areas where I think Government could, and should, intervene. Government should force the creation of this investor forum, and it should say that the financial means will be placed there for it, potentially through a contract note tax. The tax I referred to earlier on is £1 per bargain, and even then only applies to more than ten thousand shares. It is noise. I would like to see that forum correctly funded, properly staffed, and truly independent of trade bodies.

I would like to see the Secretary of State take a much stronger line on takeovers. I look back at Dr Cable’s speech to the Liberal Democrat party conference in September 2010, in which he talked about speculators dominating our economy; businesses being destroyed

by short-term gain; and vandalism, aided and supported by City accomplices.

Chair: We will be talking about takeovers in a moment.

Lord Myners: I then look at what he says in response to Kay. One can only assume that his words are drafted by the same officials who worked with Kay, because they are marking their own homework. They are saying, “Everything is alright, gov. We don’t really need to do much on takeovers,” but we do. We need to put a public interest test into takeovers and we need to slow the process of takeovers down, in order to give companies an adequate opportunity to prepare alternative proposals for their shareholders.

Chair: Could I just intervene? We do actually want to talk about takeovers in a second.

Lord Myners: I apologise.

Q93 Ann McKechin: You have mentioned several times this morning the institutional reluctance to change and how dominant their lobby has been in all aspects of their work. Professor Kay generally said the problem was that, although you can certainly change the regulatory environment, there is always a danger of people trying to find another option that they believe will be more preferable to them. You may also get a culture of box-ticking and false security. I wondered how you try to navigate these problems. If the institutional resistance is great, how do you try to nudge people into a better behavioural pattern?

Lord Myners: It is extremely difficult, Ms McKechin. Your colleagues in the Banking Commission down the corridor are wrestling with the same issue around the ring fence.

I think Kay is absolutely right in emphasising this issue of fiduciary responsibility. We need to place great clarity around the concept of the intermediary—the adviser—acting wholly and unquestionably in the best interest of the client. At the moment, we know that is not the case. The test is one of fairness and disclosure, and Kay himself makes the point that in, for instance, the area of what he calls “stock lending”, disclosure is inadequate. For the life of me, I cannot understand why the Department for Business, Innovation and Skills has not got on with the process of getting the Law Commission to work on the Kay recommendation. I am hopeful that, as a result of what I say here and what you are doing, Dr Cable will be able to tell you that this work has started by the time he gets here. I am pretty confident that, at the moment, it has not started. There needs to be clarity about fiduciary responsibility, backed up by a tough regulatory regime that says: if you misbehave, you are out—and out for good.

Q94 Chair: Can I just intervene on both you and Ann with a question I was going to ask later? I think it is appropriate to do so. There has been criticism of this recommendation to give it to the Law Commission to look at as just another way of kicking the issue into the long grass. How do you feel? Do you feel that this is a fair criticism?

Lord Myners: I have often found in my professional career, and also in the work I have done on reviews, that I have been given too much time. I am now a

great fan of saying, “Let’s get these reviews done quickly. You will get 90% of the answers in 30 days. You may get the last 10% if you make it 300 days.” That is why, if I were the Secretary of State, I would have had the Law Commission addressing this already, and would have had that investment forum up and running.

Kay is a man whose motivations are unquestionably good. I just do not think he has dug deep enough, or been radical enough. I think Kay’s recommendation here is a serious one, and it would be good to have more clarity about fiduciary duty. Maybe this is one for the Financial Conduct Authority—which is about to be launched—to deal with. There should be an absolute, undeniable obligation never to abuse a conflict; always to disclose conflicts; and, indisputably, never to disadvantage the client or put your own interest first. If you look at the language around financial regulation, you will find that it is a bit mealy-mouthed. It is a bit qualified. It is caveated, and we need to have absolute clarity here.

Q95 Chair: Would it be fair to describe your approach to this as saying that, although it is the right course of action, it could be done a lot more quickly?

Lord Myners: Yes. It would have been very nice if, in the Secretary of State’s responses—which are all couched in the language of officialese—we had felt a little bit of Dr Cable himself. That was not there. There are about three or four ways in which Dr Cable could have been much more forceful than he has been, if he really believed in these issues and if he really went back to the spirit of his views in September 2010.

Chair: Sorry, Ann, I will bring you back in.

Q96 Ann McKechin: Thank you very much. You carefully set out a series of principles to codify the model of best practice for institutional investors, and pension schemes in particular. Two years later, the Government conducted a review of the take-up of these principles in the industry. I just wondered how satisfied you were with the progress that was made on that issue.

Lord Myners: The subsequent two-year review watered down my original recommendations. That was, I think, the product of successful lobbying by vested interests. Past experience of mine—and, dare I say, of yours—might suggest that, when we get the 2014 summer review of Kay, we may well find that there has been some watering-down then. There are very few parallels where you would say, two years on, “It was tightened up.” The whole pressure of vested interests, here as in so many cases, will be to reduce impact. I was a tad disappointed.

Q97 Ann McKechin: Did it get weaker after that two-year review?

Lord Myners: Yes, it did. It gets weaker every year.

Q98 Ann McKechin: It is constant effort. Professor Kay has published a new set of principles, called “Good Practice Statements”. The Government has, again, taken a rather hands-off approach, saying that they should prompt market participants to consider

their current progress and inform industry-led standards of good practice. How long would you recommend that we wait to see if that approach works, or would you say that we should have moved a lot quicker?

Lord Myners: I think we could probably wait until this afternoon.

Ann McKechin: It is not going to happen.

Lord Myners: It is not going to happen. Despite the protestations of others, who will now come and say, “You had Lord Myners here, and what he said was totally unfounded,” I rely upon your expert judgments of people and institutions, and your experience, to form a view as to whether you think much is going to happen here. My strong sense is that it will stay as it is.

Q99 Ann McKechin: You have mentioned fiduciary duty, and you have also mentioned conflict of interest. That is interesting, because conflict of interest should be quite clear to establish. Are you saying that has got to be the real emphasis, and people have got to be pressed very, very hard about conflicts of interest and the rules should be enforced rigidly?

Lord Myners: Conflicts of interest are inherent in all business transactions and, indeed, in all aspects of life. What is needed here is an absolutely clear statement of those conflicts, but I do not think statements are sufficient in themselves. I think a legal obligation is required. I was brought up in Cornwall, and my mother was a hairdresser. She knew nothing about business. She once said to me, “You manage £6 billion. Can you write that down for me?” I wrote it down, and she said, “That is an awful lot of noughts. Why would anybody trust you?”

Trust is of a very, very high order. I know this is different from LIBOR, but what we have seen—and Kay’s central observation about the need to get back to trusted behaviour is correct—is that many, many people have lost that sense of honouring the trust placed in them.

Ann McKechin: Thank you very much.

Lord Myners: Thank you.

Q100 Paul Blomfield: Lord Myners, your breathtaking critique of the Kay Report is hugely engaging. One of the things that Professor Kay talked to us about was the difference between equity markets as they are and as they were historically. Companies basically now finance investment through debt and retained earnings.

Lord Myners: Yes.

Paul Blomfield: You would agree with that?

Lord Myners: Yes, I do.

Q101 Paul Blomfield: I guessed that you would. We have had evidence from the Quoted Companies Alliance that disagrees with this, saying that “equity markets remain an essential source of capital for new investments in British business”. Given these conflicting views, what future role do you see for the equity market in the long term?

Lord Myners: I have suggested—and this has been one of my key arguments—that perhaps too many companies are publicly quoted, and that for some of

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them it would be better if they were institutionally owned than private. The primary source of new flotations and new capital in the UK stock market in recent years, and the primary provider of funds, has been Her Majesty's Government in their financing of the banks. It is a bit naughty of the Stock Exchange to include that as evidence that the capital markets are performing a function: I would argue that the capital markets had clearly failed, which is why the taxpayer had to step in.

Of course, we have also seen a lot of Eastern European and emerging market companies coming to the market, but there are very few examples of UK companies coming to the stock market with what is called an "offer for subscription", as opposed to an "offer for sale". An offer for subscription is when a company raises new capital: they issue new shares to new investors to support investment. An offer for sale is when the existing owners, be they private equity, oligarchs, or whoever else, sell the shares that already exist. The capital has already been invested. In many cases, you see companies saying in their prospectus that "the company has no present plans for the use of the funds raised" when there is an offer for subscription.

The fact is that often offers for subscription do not have a clear investment programme linked to them. In any case, offers for sale dominate over offers for subscription, and more small UK companies withdraw from the stock market, rather than come to the stock market. This all seems to me to pull the rug completely out from under the argument that the Stock Exchange is a key provider of capital for British industry.

Q102 Paul Blomfield: Thank you. I know Robin is itching to get in on takeovers and acquisitions, and to follow that discussion further. I wonder if I could just ask about one other point that you raised. You criticised Kay for saying nothing about a financial transaction tax. If you listened to the report on Radio 4 this morning, you would have heard a debate around the movement within Europe: whether all 11 countries could, on a Europe-wide basis, move towards an FTT. It was all about the money that was raised. In your criticism of Kay, you were talking about microseconds of ownership, and some of us struggle to understand this. What is your view on the FTT in terms of changing behaviour, as opposed to raising revenue?

Lord Myners: I did not listen to the radio this morning, Mr Blomfield. I was a bundle of nerves in preparation for coming here, and so I did not allow myself to be distracted. I know I have been critical of Kay, but, as I have said, it is a good analysis. I am just fearful that not many other people coming before you are going to give contrary arguments, so I probably over-emphasised some of my criticism to ensure the balance of argument there.

I am positively inclined in support of a financial transaction tax to slow down the pace of hectic deal-making and trading. I am not much persuaded by arguments to hypothecate the proceeds for one reason rather than another. I think the primary economic argument for a financial transaction tax would be to reduce the super-hectic activity, which, to me, is

epitomised by these high-frequency, algorithmic traders. These are people for whom physically getting their computer closer to the stock exchange, or using even faster bandwidth cables, is critical for business success because they own the shares for microseconds. What have we done? How have we ended up in a situation where the evidence and responsibilities of ownership of our major companies can be traded in milliseconds? I don't think Kay really got to grips with that at all.

Q103 Paul Blomfield: What about the argument that, if we do move towards FTT for that reason, it has to be all or nothing? There has to be complete international agreement, or it will damage our financial services sector.

Lord Myners: The Government is correct in arguing in favour of, ideally, a global FTT. It is quite difficult to introduce. It is quite interesting that EU proposals seem to be extra-territorial, and will apply to transactions conducted in UK securities and by UK-based institutions. I do not think the Treasury has ever looked seriously at the economic case. I think they have been somewhat dismissive, because they see it as threatening to the City. One thing that I think both Professor Kay and I would agree on is that we have too often been concerned about things that are threatening to the City, and have missed the point that, at times, the City is threatening to the economy. I find myself increasingly drawn towards a financial transaction tax: ideally, one that is established globally.

What if it were not global? This is a bit like offshore financial centres. My simple solution to offshore tax centres is that we should not allow any bank in a developed company to establish a branch or a subsidiary in an offshore centre that does not comply with the OECD's white list of financially compliant economies. You could do something similar in terms of transactions. You could say to the Barclays, the Citibanks and the Société Générales that, if they put transactions through a non-FTT-compliant jurisdiction, they would lose some of their financial privileges from being in well regulated markets. I think these things could be achieved, Mr Blomfield, if there is the will to do them.

Paul Blomfield: Thank you.

Q104 Chair: Before I move on, did you consider doing those things when you were a Minister?

Lord Myners: There are lots of things I wish I had done when I was a Minister. I wish I had spoken up more than I did. I came in as a Minister just after the collapse of Lehman Brothers, specifically to do work on the recapitalisation of the British banking system within the Treasury. I was very rarely consulted by colleagues on tax matters, but I do wish I had spoken up on this issue.

Chair: Thank you.

Q105 Mr Walker: Lord Myners, you have given us plenty to chew on. It has been a very interesting discussion so far. I want to touch on M&A, but, first, a broader question. I think that you and Professor Kay have been very clear in your criticisms of the current

nature of the City, the way it treats companies, and the way it has changed the nature of ownership. I think we can all feel sympathy with some of the criticisms that have been made. However, are you not both open to the accusation that you are trying to turn back the clock to a mythical time in which all investors behaved well and understood their fiduciary responsibilities? Are not some of the changes really to do with technology, the rise of globalisation and the fact that we are living in much smaller world, where investors have much freer movement of capital? Is it not unrealistic to think that we can necessarily change all of that through legislation or regulation?

Lord Myners: That is a very good question. Your background in financial PR shines through. No, I don't think I am trying to take us back to some golden age. I am asking whether everything that is listed under the heading "improvement" is actually an improvement. One does need to emphasise that, on the whole, fund portfolios now have more holdings than they used to. That is a high-level generalisation, because you have got some very commendable activist funds that hold investments in only eight or 10 companies, but, generally speaking, portfolios have become more diversified. Academia has encouraged this though modern portfolio theory and capital pricing models.

I am suggesting that it has gone too far. I think high-frequency trading has gone too far. I think M&A—which I know you want to come back to, Chairman—has been hugely damaging to the UK economy, and yet it has suited City institutions. I want to see the voice of the true owner expressed in these areas. Actually, if I look at the people who are giving evidence to you, I do not think you have got a single true owner giving evidence to you. You have always got intermediaries. There is a sort of hankering element. I hope I am not giving the impression that I think all progress is retrogressive, but I cannot, for instance, persuade myself that high-frequency trading is a good thing and that we would all be worse off if it had not been invented.

Q106 Mr Walker: Coming on to M&A, we have looked at evidence that described the Cadbury-Kraft deal as a disaster for the UK. You yourself have said that this is something that is undermining the position in the UK. Do you think that your recommendations, when you put out your report, should have been different in the light of the M&A we have seen? What would you have changed?

Lord Myners: I was a younger man, and my views have hardened. I said very little about M&A in my report, other than to point out that most M&A transactions do not deliver the outcomes that are suggested. I have subsequently gone on to say that the Takeover Code is rather like the British guns in Singapore in the Second World War: they were pointed in the wrong direction. The Japanese invaded not from the sea but from the Malay Peninsula. The Takeover Panel largely focuses its attention on the shareholders of the target company, and not on protecting the interests of those in the acquiring company, who are often subject to serious value destruction as a result of the egos and hubris of

company executives. I wish I had been more critical of takeover activity.

The problem, Mr Walker, is that the prevailing sense throughout most of my career in the City has been that takeovers are good because they sort out badly performing businesses. If you do not run your business well, it will be taken over, and the new people will run it much better. That has suited the intermediaries. It has suited the investment banks, the stockbrokers, the fund managers, the lawyers, and the accountants. They, in turn, have persuaded the regulators that this was good, but the actual evidence just does not support that conclusion. In fact, takeovers on the whole fail. We should have a warning rather similar to that on a packet of cigarettes on the sort of takeover documents that you and I have worked on in our careers: "This type of activity tends to destroy value."

Q107 Mr Walker: Surely the logical extension of what you are saying is that this is, in many ways, a call for greater shareholder activism, which is a point you made.

Lord Myners: Yes.

Mr Walker: Would you say that, therefore, you ought to have the acquirer having a vote amongst their shareholders as to whether they should be going ahead with deals, rather than the target voting whether they should be taken over? You might see more shareholders speaking up against deals.

Lord Myners: That is correct. However, the problem there is that we have had one or two examples—I can think of two in the last 20 years—where shareholders in the bidding company have persuaded the board not to proceed with the bid. I guess G4S might be the most recent example. It is quite a nuclear solution, because there is a fear that, if you say to the board, "We do not support your recommendation," you are effectively saying that you do not have confidence in the board, and the shareholders do not want to lose the management necessarily. It is a rarely exercised option.

Another issue that we have here, Mr Walker, is that most of the institutional investors who come before you will say, "We don't like being made insiders. We don't like to give up our right to deal. We love dealing. If we are going to be made insiders, we only want to be made insiders for 24 hours." The right approach, used by the activist investors that you refer to—and I am involved with an activist fund—is to say, "We relish the opportunity of being insiders. We would like to be insiders. If that means we can't deal for a month or so, that's neither here nor there if we get the chance to have a voice."

However, most of our institutions do not want to be insiders. They do not want to get involved with a company and say, "We really don't think making that bid makes sense. That isn't what we want you to do." Institutional investors should be saying to companies, "We don't want you to diversify. We diversify in our portfolio. You stick to what you do really well." That voice does not, on the whole, get expressed.

I have sat, Mr Walker, on the board of—I think—11 or 12 FTSE companies in my career. I therefore speak with some experience regarding the fact that there is

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very little contact between companies and their shareholders, other than meetings in which the shareholders are seeking information on the company that gives them a possible trading insight. Most of the dialogue between companies and shareholders is one in which the companies speak and the shareholders listen. The shareholders rarely speak back in terms of their priorities. Activist shareholders do that. They are rather like the white blood cells in the system: they are a force for good.

Q108 Mr Walker: That is a very interesting analysis. Obviously, you are speaking both from the perspective of having worked with companies and having worked with an activist shareholder. I would say, though, from my experience, management tends to be rather wary of activist shareholders. They tend to be rather defensive when activist shareholders take a stake in their company.

I just want to move on to the issue of short-term share ownership. Coming back to the Cadbury-Kraft example, about 5% of the company was owned on an ongoing basis by short-term shareholders. When the takeover was under way, that rose to about 30%, and we have seen that in a whole range of M&A situations. It clearly has an impact on the likelihood of M&A deals going through. Do you think there is any way of differentiating between the voting rights of short-term and long-term shareholders, and do you think that is something we should be looking at?

Lord Myners: This is not easy. I was made Chairman of Marks & Spencer three days after the bid by Philip Green and Goldman Sachs. Over the six weeks that it took us to prepare our defence proposal regarding the other option, namely remaining independent, short-term share traders acquired nearly a quarter of our shares. Many of the long-term institutions sold out, with the commendable exception of Standard Life, who absolutely said, "We will do nothing until the company has a chance to speak." Many other shareholders sold out.

The short-term investors have a very different interest. They are not long term. They are not persuaded by an argument that says, "This is actually a really good company that has not been particularly well-managed in recent years. Stick with the company; invest in the future. The company looks after its employees and its customers well," etc. That argument appeals to a long-term owner. It is an irrelevance to a short-term investor who is here today and gone tomorrow.

Some restriction on voting by short-term investors has a certain appeal. However, as Ms McKechnin said, the City is rather good at finding ways around these things, through contracts for difference, etc. I am unpersuaded. My key recommendations on takeovers, Mr Walker, are these: firstly, the Secretary of State should exercise far more powers to intervene to stop the level of takeover activity, and to direct companies more towards self-investment.

Secondly, I would recommend that the pace of takeovers needs to be slowed down to give companies more opportunity to put alternatives forward. You can take over a British company in less than 30 days. There is no other developed economy in the world where it is easier to take over a company, and so we

get a bad outcome. Kraft is a huge conglomerate that is not going to be a good owner of Cadbury. Cadbury and its products, people, culture and values will be lost within the enormous business of Kraft. Most of the investors in Cadbury had the choice: they could have invested in Kraft, but they were not invested in Kraft. They were invested in Cadbury. They recognised that Cadbury was superior, and yet these short-term pressures led them to sell out. I would much rather be an investor in an ongoing Cadbury than in a Kraft, a company that struggles to make a profit in excess of its cost of capital.

Q109 Mr Walker: Following up on that, and this area around foreign takeovers: you accused Kay of being almost xenophobic in your opening comments earlier, but you are also saying that there ought to be a greater public interest focus. You are saying that the Secretary of State ought to be being more interventionist in these processes. There are challenges with that. I mentioned to Kay two weeks ago that one of the deals I worked on was the Arcelor defence against Mittal. You had a lot of countries there that were very keen to be interventionist, but at the end of the day, they were brushed out of the way by the overpowering will of the hedge funds and short-term investors, who wanted to force through a deal. Despite the fact you had politicians in France, Luxembourg and Holland jumping up and down about it and saying that it should not go ahead, the weight of shareholders won out eventually. If there were to be some kind of public interest test or some kind of role for the Government in protecting UK companies, how would you say that would work?

Lord Myners: I think that as much damage is done by M&A of British acquirers of British companies as is done by foreign acquirers of British companies. I am not being xenophobic here: I am simply saying that our rules seem to be extraordinarily permissive, and one might sit back for a moment and ask whether it is actually in the benefit of the economy and society, and why we have concluded that we want to make it so much easier to take over companies than elsewhere. Martin Lipton, who is one of the leading lawyers on takeovers in America, told me recently that there had not been a significant successful hostile takeover of an American company in the last six years. We have had dozens in the UK over the last six years.

These things link together. Fiduciary duty would require the ultimate owner and, through contract, the fund manager—whether it be a good activist or another type of investor—to be able to defend the actions that they took on the grounds that they were in the best long-term interests of the beneficiary. It is quite clear that selling out to the highest bidder is not always in the interest of a long-term investor. I think that Section 172 of the 2006 Companies Act needs a bit more clarification as to what is right. Selling your Cadbury shares today to Kraft, rather than saying no and seeing the Cadbury share price fall if Kraft fails, is not necessarily contrary to the interests of the end owner. It is only contrary if you are addicted to market accounting and think that shares are for trading. I would be very happy to take the side of the argument that says, "I would rather have retained my investment

in the old Cadbury than invested in Kraft.” Cadbury was an international company: 40% of its shares were in international ownership. I do not think, Mr Walker, that that argument is ever really given a chance to be expressed now under the rules and approaches that we have for takeovers. We regard shares as things to be bought, sold and traded, rather than having some deeper entitlement and obligation.

Mr Walker: Thank you very much.

Q110 Chair: Just to pick up one point: in your opening remarks, you said that the Takeover Code in effect encourages the speeding up of takeovers. Could you just clarify that point?

Lord Myners: There were number of modifications to the Takeover Code announced. I am trying to see if I can find the evidence, sir, in the Secretary of State’s response. I think it was recommendation 14, in which the Secretary of State lists a number of areas where changes have been made to the Takeover Code, such as the “put up or shut up” period being limited. There is uncertainty around this. It is a technical issue, and I am happy to write to the Committee.

Chair: That would probably be best.

Lord Myners: Having read Kay several times—in fact, it could well be my chosen subject on *Mastermind*—I have still, at this point, failed to find the relevant section. I would essentially say that the fate of no company should be determined in less than six months. Some will say that this will cause tremendous uncertainty, and ask how a company can survive during that uncertainty. They will argue that this must be resolved very quickly. The people saying that are the agents and fee-chargers: the accountants, the lawyers, and the investment banks. We often lose sight of the fact that companies have a heart. They employ people; they have customers; and they have got communities dependent upon them. Those voices do not get heard at all.

Q111 Chair: Isn’t one of the accusations made by the financial services industry and participants against the 28-day “put up or shut up” period that it is not enough time, and that it actually blocks takeover activity? I believe there is a six-month period after that in which they cannot make the same approaches.

Lord Myners: You are absolutely correct, Chair. I have just not been persuaded that this argument that companies cannot be kept under siege for a long time is necessarily the right way to see the issue. I think the argument that companies should not be placed under extensive siege has been used to reduce the period that is available to assemble a credible alternative. When a company receives a takeover, the duty of directors is to carefully evaluate that proposal, but to also evaluate other proposals, including the possibility that the company has in some way or another failed to deliver its true potential to make necessary changes. When I became chairman of Marks & Spencer, we replaced the chief executive at the same time. We brought in a new chief executive, and we gave the shareholders a better option than the one they had previously been given. In the end, for a number of reasons, that is the option that they were happy to support. I would like

to write to you on the “put up or shut up” period. It is quite a narrow area.

Chair: It is quite a narrow area, and your points seem contradictory to a certain extent.

Lord Myners: They are.

Q112 Mr Walker: In the Marks & Spencer case, what happened at the end of the day is the shareholders decided that you were presenting them with a better option. In many cases, that can be the case. So much of what you are saying about takeovers is really a call for more activist shareholders. Shareholders should be voting with their money, putting their money where their mouth is, and—if they believe in the long-term future of the company—should be willing to buy the shares away from those short-term investors and make sure a takeover does not go through. That is not necessarily an argument for greater Government intervention.

Lord Myners: We have not talked about short-term reporting, or the focus on data, measurement and companies reporting. I am broadly sympathetic with the direction in which Kay goes, although I think he again misunderstands what goes into an IMS. If you have a portfolio that is over-weight Marks & Spencer—you have got more than the index weighting—and along comes Goldman Sachs and Philip Green with a bid and the share price goes up by 50%, and you have got 5% of your portfolio in that, that is a very nice lift to your quarterly performance.

You are quite reluctant to say to the client, “We underperformed last quarter by 0.1%. If we had accepted the Marks & Spencer bid, we would have outperformed. That would have added a quarter-percent to our performance: i.e. plus 0.35% for the portfolio for the quarter. In our professional judgement—which we are happy to explain and defend—it was in your best interest that you retain your investment in this company, given that you are a long-term investor. We do not think the market is of much concern: to the extent that the share price falls after the bid is withdrawn, then we will know more about the company, and we have actually increased our investment in the company.” That is the way a mature and well rooted approach would be formulated, but it is not the way it works at the moment. All of the focus is on short-term performance.

Q113 Chair: That anticipates a question I was going to ask on quarterly reporting. It is proposed that it will be removed, and replaced by “narrative” reporting. Do you think there is a risk that companies will simply stop producing quarterly reports and not do anything about the narrative reporting, or do narrative reporting in such a way that it is totally unhelpful?

Lord Myners: It is quite interesting that, when Gordon Brown was Chancellor, he was very attracted by narrative reporting for a while. He wanted to introduce what he called an “operating review” in annual reports and accounts. In around 2007, he suddenly dropped it without any real explanation as to why he had. I have never asked him why he did that.

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I have sat on the boards of American companies, where there is much more narrative reporting. In some ways, it is harder for the directors to pull the wool over the eyes of the shareholders in narrative than it is in numbers. In numbers, you can fudge all sorts of things. You can put apples with pears and call them lemons, and your auditors may well allow you to do that. It is when you come to express in words what is happening in the company that the directors get quite exercised about their legal liability if their statements are not full, clear and unlikely to be ambiguous.

I quite like the idea of narrative reporting. I think where Kay is wrong, Mr Chairman, is that the IMS issued by most companies is a single page. It does not say very much.

Q114 Chair: Coming on to that, what do you think should be the standard elements in a quarterly narrative report?

Lord Myners: You might start off by saying to the directors of the company, "Let us assume that you are a non-executive director on a board. You probably own no shares, or very few shares, in the company in practice. You attend board meetings one day a month, and you have got other things that you are doing, so you are not very busy. Let us assume that, by some act of fate, you have suddenly become the owner of the whole company. You, the independent director, have now become the owner of the whole company. However, you also have multiple responsibilities, which means that you can only meet with the management once every three months, and you can only afford them 10 minutes. What would you want them to tell you in that 10 minutes? What would you want to know in that 10 minutes? You are the owner of this business in perpetuity. You cannot sell the shares—you are not much interested in the share price, because there is not a share price—and you only have a short period of time. What would you want to know about the company in that 10-minute meeting every quarter? Write that down, and then compare it with what you tell your shareholders, and try to reconcile why there is such a huge difference between the two."

Q115 Chair: That is a very interesting way of answering the question. Since we only have a very short period of time, could you very succinctly say what you actually think should be in them?

Lord Myners: I think you would want to know about the long-term health of the business. I would want to know: "What have you done, during the three months, to make this company stronger?" I would want to know about customer relations. I would want to know about employee relations and supplier relations. I would want to see the company in its network, essentially, rather than in isolation. I would like to know what you were doing in terms of investment in research and development. I would probably like to know the five things you have done in the last quarter that you are most proud of, and the five things you feel you have made a hash of. That might push it for 10 minutes, Chairman. A brief financial schedule with a focus on how much cash the business has generated

and how that cash has been spent would be sufficient for my purposes.

Q116 Chair: Thank you. That is helpful. I would now like to ask you about something that I have difficulty in understanding, which is "asset allocation asymmetric information". In the introduction to your review, you said, "A particular consequence of the present structure is that asset allocation ... is an under-resourced activity." Can you just explain that to me as a layman?

Lord Myners: There are two different issues. There is asymmetry of information: everybody is trying to get the same information. Our approach to efficient markets has been that, if everybody has the most up-to-date information available and they all have the same information, then we get efficient valuation of companies and rational allocation of capital. That has, perversely, restricted the flow of information between companies and their investors. That is why I think that the activist investor who says, "I want to be an insider, and I want to sit on the board of directors," is so much more positive for a company than this widely distributed ownership. The asset allocation model in the way in which Kay uses it is, I think, how a pension fund splits its money between bonds, equities, private equity, property, etc. It is how the fund gets to the optimal point on the efficient frontier of the balance between risk and return. I have spent too much time reading Professor Kay's academic works if I can give an answer like that.

Q117 Chair: Could you just explain this "under-resourced" bit?

Lord Myners: There is an inverted pyramid in investment management, in which the least important functions receive the greatest attention and the highest pay, and the most important function receives little attention and, frequently, no pay. Let me expand on that. Multiple dealers of listed equities in active portfolios who are pursuing what the trade calls "alpha" are trying to out-perform each other. They cannot in aggregate, by definition, out-perform. There cannot be aggregate alpha, so this is a complete waste of time. There is an awful lot of dealing activity in which some will succeed and others will fail. As Kay says, there is very little evidence of sustainability of advantage: this is to say that, even if you have succeeded in the last five years, it is rather like flipping a coin. The fact that it has come up heads five times in a row does not actually tell you that it is going to come up heads next time, but the City seems to work on the basis that it does. This is an area that receives a lot of pay and a lot of attention. Some of the richest people in the country owe their fortunes to this type of activity.

By contrast, the decision on asset allocation for a pension fund—which is about understanding what your optimal level of risk is, creating a risk budget, and then saying that you will invest X percent in bonds and Y percent in equities—is taken by trustees who are often unpaid; who are generally not professionals, or particularly economically knowledgeable; and who are led by the nose by consultants. The most important decisions are taken

by the people with least economic incentive and interest in the outcome, little reward, and little experience. On the other hand, the decision that adds no added value at all is hugely rewarded and in receipt of intensive scrutiny 24/7.

Q118 Chair: That is very helpful. Kay actually seems to think that developing this concept of fiduciary duty may help in making that asset allocation more efficient. Do you agree with him?

Lord Myners: I do. I think anything that makes clear where responsibility lies would be advantageous. Kay and I were aligned on that. Kay, if he read this transcript, would probably say, "Paul, you were very unfair, because there is much more that we have in common than we do not." I would agree with that. I might have sounded coruscating in my comments on Kay, but I just wanted to make sure that you do hear that there is an alternative view to the one that I think most people are going to give you over the next few weeks.

Chair: Thank you.

Q119 Mr Walker: That is a very helpful clarification. One of the things that you and Kay seem to agree on as well is the complexity of the intermediary chain between companies and the equity markets, and you commented that that has been becoming steadily more complicated since the 1960s. Kay has said he thinks that is a problem for the market. Is there any way we can change it? Is there any way that complexity can be broken down?

Lord Myners: I think an informed group of trustees would begin to look at how many people are eating off this carcass. We have got the guards, the guards of the guards, and the guards of the guards of the guards, and in a low-inflation, low-economic growth environment, the amount of investment return that is being absorbed by unnecessary fees is, in my view, quite high. I have made it quite clear to the Committee that I am a keen supporter of activist shareholders. I believe that activist shareholders, if they do their job well, are really a force for creating good and strong companies. I find myself much less persuaded that the hyper-dealing activity of algorithmic trading, etc, adds value. I think one of the things that should happen here, Mr Walker, is that the trustees of pension funds should be much more questioning about whether there is a different way to do things; whether they need to be paying all of these fees; and whether they are convinced that they are getting value for the fees.

Q120 Mr Walker: Is there an issue with the structure of the sell side—the intermediaries—and the way that has changed, particularly since the Big Bang and the shift towards a trading mentality that is transaction-based rather than relationship-based? I think I asked this question of Kay: is there any way of turning the clock back on that? Is there any way of having a more relationship-focussed set of intermediaries who are going to be talking directly to those investors and developing long-term relationships with them and with the companies?

Lord Myners: I have never been convinced that the so-called "sell" side is the optimal way of providing

a bridge between investors and companies. If you speak to most companies, they say they would like to have long-term investors with whom they can have a sustainable, continuing dialogue and relationship. They would like to have fewer shareholders, so that they have fewer people to meet. The standard for a chief executive of a company is that, twice a year, they announce their results, and then they spend four or five days, meeting 10 institutions every day, in London, Edinburgh, New York, Boston, and San Francisco. They would much rather only have a couple of shareholders to meet, or four or five shareholders. They would prefer to spend longer with them, rather than have an adviser looking at their watch and saying, "It's 10 minutes to the hour: we have got to be moving on."

The model in which we have a huge number of shareholders, and where the bridge between the company and the shareholder is often through the form of a sell-side analyst, seems to me to perpetuate that constant movement in ownership. The sell-side analyst makes their money from transactions, Mr Walker, as you and the Committee know. The company says they want to have a stable, long-term shareholder base. Yet, when they communicate with their owners, they often do it through the use of a sell-side analyst whose own economic model is predicated on the absolute reverse, which is an ownership that changes every hour.

I think there is an opportunity. The transactional approach that Kay has identified as being very different from the old model has been a global phenomenon, not just limited to the UK. It is not easy to reverse, but the right way to change it is to be clearer as to the deficiencies of the current model.

Q121 Mr Walker: You have been quite critical of Kay for not suggesting more specific things that could be done. We can be clear about the deficiencies, and we have been very clear in our analysis of what the problem is, and I suppose that a financial transaction tax could potentially be part of that solution. Are there any other practical changes that you think could deal with that culture of very complex and aggressive intermediaries who are effectively pushing a transaction model?

Lord Myners: He who pays the piper calls the tune. The problem has been that the person who pays the piper has been somnolent, and has expressed no particular preferences for any type of tune, or even the quality of playing. He who pays the piper is the trustee of the pension scheme. In that area, I absolutely remain on rock-solid ground with my own review on institutional investment, which could be summed up as saying that the pension fund trustees have just got to get smarter and be more on the ball. That is a source of change, Mr Walker. Achieving that is more important than anything else, but I think that areas like fiduciary duty, an investor forum and more disclosure are all helpful. However, it is getting the trustees as close as you can get to the ultimate owner, which in most cases is the director of the investment company or the trustee of the pension scheme, to ask more fundamental questions about whether there is a better way of doing this.

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What we have seen in the Kay Report is that public companies and the public company ownership model, as we currently know it, is not producing good economic outcomes. I will come right back to the beginning: is there anything in Kay that is going to enhance the performance of the UK economy, and lead to greater and broader prosperity and a stronger society? I do not think there is anything in Kay that is going to make any significant progress in that direction. We need to keep focussed on that core aim and ambition.

Q122 Mr Walker: Just one more question, if I may. You talked about the position of the pension fund trustee, and their motives are very clear: they want to get the best return for their pensions, which is very worthy. You yourself have talked about sovereign wealth funds and the role that they can play, and you have talked about the more concentrated ownership they can provide and the fact that sometimes they will be investing in private companies, rather than just public ones. Is there not a concern, looking from a UK plc perspective at sovereign wealth funds, that their motives may not be quite so transparent? Their motive, rather than simply being to get a good return for their shareholders, may be something more than that: something political, or something about access to resources when a sovereign wealth fund takes a stake in a company. Is the role of sovereign wealth funds not something that other investors ought sometimes to be a little wary about?

Lord Myners: That is another very good question. The taxonomy of sovereign wealth funds is very broad and complex, and it is therefore quite difficult to generalise. Some sovereign wealth funds undoubtedly have a quasi-political objective. Other sovereign wealth funds have actually eschewed that, and are almost frightened of appearing to be too engaged as owners, through fear that they will be accused of seeking to exploit extra-territorial political influence. One has got to look at it case by case. I could list those sovereign wealth funds that I thought were more politician and those that were less political, but, as you can imagine, I could not possibly do that in a public forum.

Q123 Rebecca Harris: Good morning, Lord Myners. As someone with no prior background in this area, today has been an education for me. I am delighted that this inquiry looks to be a lot more engaging than the rather dry one that, I confess, I was expecting. Thank you. My first question is: could we, or would we, be able to use pay and remuneration to try to incentivise a better alignment between shareholders, fund managers, directors, and the wider public?

Lord Myners: I am sure there are plenty of dry sessions to come. I use the word “alignment”, which is a word that intermediaries quite like. Increasingly frequently, fund managers now put on company directors the same objectives by which they are themselves rewarded. The fund manager is told by his client, “We want you to out-perform the index over rolling three-year periods,” either a broad index or an industry-specific risk. So what do the shareholders do?

We need to always be clear about the difference between a shareowner and the fund manager.

The fund managers then try to put similar obligations on the company chief executive, and the board directors are told that their bonus is dependent upon how well the share price does over a rolling three-year period. The fund manager feels under a short-term performance pressure, and so they absolutely replicate that in the arrangements put in place for company bonuses. It is not surprising, therefore, that many companies say they feel under great short-term pressure. Academic evidence shows that, when asked in confidential questionnaires—admittedly, in America, but I do not think it is necessarily different here—company directors say that they would probably cut back on research and development that they really thought would produce good results if that would enhance their share price. We have got an alignment that is the wrong sort of alignment. We have got an alignment around a common interest in short-termism.

If we go back to my model of where I would be if I suddenly found I had inherited the whole company, I would be much more interested in saying to the chief executive at the end of that conversation, “I think you have done a good job. I like what I hear, and I am going to make a judgmental decision because you are building a good, long-term company. I am just not interested in short-term performance.” But at the moment, Ms Harris, I think the alignment has been around enforcing short-termism, rather than the reverse.

Again, under this fiduciary responsibility, the shareowners ought to be asking whether putting the chief executive under a cliff-edge pressure not to underperform the index over a rolling three-year period really creates great companies. There is a profound belief that the market values companies correctly at the beginning and the end of the period, which I think is deeply questionable. If you underperform the index over a rolling three-year period, you will get no bonus, or very little bonus.

So what does the chief executive do? The chief executive gets out on the road. He tells the story of the stock. He re-levers the balance sheet. He buys in and cancels shares. He does an opportunistic M&A bid about which he can talk positively for a short period of time before it becomes evident that the bid has not worked, in which case he is then on a treadmill of doing another one. We have reinforced a short-term focus through remuneration, which is very distinct from the behaviours that you see in true long-term, great companies. These are frequently unlisted. Some of the best companies in the world are either unlisted, or are listed and have a significant anchor shareholder who focuses on the long term and not the short term.

Q124 Rebecca Harris: Professor Kay specifically recommended that performance incentives for company directors should be shares, held at least until they have retired from the firm. That makes sense to me, as I come from a small family firm: from my perspective, that is how business always was. What do you think about that?

Lord Myners: Conceptually, it is rather attractive, but it is wholly unenforceable. Logically, you would sell your interests through derivatives. You might leave the company in order to be able to sell. There is a point, Ms Harris, where a director can actually have too much of their wealth invested in the company. They become too obsessed with the share price.

Most of the people I truly admire in business are not motivated by money alone. Most of them are motivated by wanting to create great companies. Kay makes some very interesting points about ICI and GEC. He contrasts how they used to be with how they became when the City got a grip on them. Look at banking: when I was a young man, to be director or regional director of Barclays Bank or Martins Bank was not a recipe for making huge amounts of money. You were well off—you were a prosperous and respected member of the community—but you did not have private jets and all of the things that Mr Bob Diamond and others seem to have ultimately been motivated by. If the only way you can keep your management team is by paying them more and more, then you probably have not got the right management team.

Q125 Rebecca Harris: It is not necessarily about paying them more money; it is about paying them in the long term. Is the point not that your rewards are a long way away?

Lord Myners: I can understand that, but I might reverse it. I might say that it is not the fact that your rewards should be a long way away; it is the fact that your vision should be to the longer term. Are you doing things that will create a better company in the long term? One of the other problems we have in remuneration is that most of these remuneration agreements are now very formulaic. They are based on things like total shareholder return, etc, and weak and lazy directors have come to rely upon formulaic decision-making rather than exercising judgment. A really good board of directors would look at it and say, “Madam Chief Executive, we think you are doing the right things. We think you are creating a stronger company with a significant future. The stock market does not necessarily agree with that at the moment; we are not much concerned with that. We know more. We are going to give you a reward that we think is appropriate to the value we think you are adding long term.” That is not the way it works now. Thinking long term is important, but I do not think that thinking long term necessarily means that the disbursement of the reward should be long term.

Q126 Rebecca Harris: It is just that I can see the attraction. You realise it is many years down the line, and if you have not made sure the company is in good health for the future, then it does not work for you.

Lord Myners: It is rather romantic. You can say that you cannot realise these shares until your retirement, but the fact is that most of us are not in wealth-accumulation mode when we get to retirement; we are in wealth distribution mode. It would be odd to live on a modest income until the age of 60, and then suddenly have wealth beyond the dreams of avarice

dumped on you as the reward for 40 years of loyal service. I somehow do not think that would work.

Q127 Rebecca Harris: We have already covered quite a lot this morning about short-termism. You and Professor Kay might agree on the need to adjust the timescales in which success is measured for asset managers. Is there anything you would like to add on that, in terms of getting extra clarity?

Lord Myners: Most asset managers would welcome anything that encouraged them to believe that their clients would support them over a longer term; that their clients were less focussed on the very short term; and that their clients were less focussed on how they did against the index. One of the terms that you hear in the fund management industry is “tracking error”. Tracking error is how you measure the extent to which a portfolio deviates from the index. Most active—as opposed to activist—fund managers monitor very carefully the extent to which there is a risk of them markedly deviating from the index.

Most fund managers regard themselves as in some ways enslaved by this, and would say in their true hearts that they would rather be able to run a portfolio with a higher tracking error. This would deviate from the index over short and medium time periods, but would produce superior long-term returns because it held fewer investments and was a more concentrated portfolio. Kay and I are both in favour of more concentrated portfolios. However, Kay does not get to grips with these things. He talks about the benefits of concentrated portfolios, but does not ask, “Why is this happening?” He does not seriously explore why portfolios are so substantially diversified, which is disappointing.

Q128 Rebecca Harris: I was going to ask you a question about FTT, which you largely covered in your discussion earlier with Paul Blomfield. You were very convincing on the benefits of this as a means of reducing short-termism, but how would you counter the argument that this is simply a tax on pension funds, and another point at which there is feeding on the carcass?

Lord Myners: The primary purpose of tax is to raise money to support programmes approved by Parliament, but there is a secondary function of tax, which is to achieve what are judged to be economically or socially beneficial outcomes. My thesis would be that a sensibly constructed FTT would actually be of benefit to pension funds. That is to say, it would calm down the excessive trading and deal-making that represents a significant cost to pension funds. In an environment in which trading was significantly diminished by a sensibly constructed tax, the net cost of the tax would be lower than the net gain of excessive trading. I come back to my core observation here, which is that hyperactive trading can add no value. For every winner, there is a loser. It is not even as good as that: if there were a winner for every loser, then there would be no disadvantage. There is disadvantage, because every trade bears a cost. There is what is called a bid offer spread between the price at which people will buy your shares and the price at which they will sell them on, which is

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leeching money out of the system to the benefit of intermediaries.

Q129 Chair: Thank you. Just moving on, and trying to pull all of your comments together: you conducted your own review. We have had Kay 10 years subsequently. Kay has made a lot of recommendations in theory, although there are issues about how robust they are, and exactly how they involve some sort of positive action by the Government. Given the experience you had when you did your report 10 years ago, and looking at Kay and his recommendations, how would you beef up those recommendations to actually achieve the sort of ends that you and Kay are broadly in agreement on?

Lord Myners: A number of Kay's recommendations are very much motherhood and apple pie.

Chair: I described them as such, too.

Lord Myners: They are good—I do not dissent from them—but they are not going to happen unless there is more of a forcing mechanism. The key in the report is that the fiduciary responsibility obligation potentially has the ability to be more of a forcing obligation. The Government's response to Kay was very vapid. I could not really tell from reading it whether the Secretary of State was punching the air and saying, "This is just what I wanted: this is going to make the change that I want," or whether he was saying, "This is another thing I can cross off my to-do list until I get called in front of Mr Bailey and his Committee." I have a slight inclination that it was more of the latter than the former.

I think that the Secretary of State has really missed a point on this investment forum, Chairman. He should have said to the investment industry, "I am going to invite three people to set up a group to tell me how this forum is going to be established. I am going to get them to set out what the options are. I am going to get the industry signed up, and I am going to give them 30 or 60 days to get that done." As far as I am aware, there has been a lot of discussion and very little progress on creating this investment forum. However, I am confident that by the time they come to talk to you they will have done it, because I fingered them for not making progress. On M&A, there is a single sentence from the Secretary of State that says he is going to look at competition policy and mergers and acquisitions, and that he hoped to produce something in, I think, early 2013. One of the things I learned as a Minister was that the phrase "early in the year" can, in Government, apply to anything up until 30 June.

Chair: We have found the same.

Lord Myners: Reports produced for the summer, as well, can often stretch well into October or November. I would like to have seen Dr Cable get much more involved and engaged here than he has done, and I still think that there is an opportunity for him to do that. I have nothing else to add, Chair. I think Kay has got a beta-plus for this report from me.

Q130 Chair: We could probably second-guess the Secretary of State's position on this for quite a long time, but it could be that Kay was set up to give recommendations—to do the work and make the

recommendations—to provide the basis for a policy initiative by the Government. It has not really delivered on that. What would you put in to actually give the Secretary of State something to say in terms of, "We have got the evidence. These are the recommendations. I believe that we should go forward on them"? At the moment, he has not really got those recommendations to go forward on.

Lord Myners: Having authored a number of reviews, I have become familiar with the process under which the review team prepare the report with the reviewer. They then pass it from their left hand to their right hand, and they draft the Secretary of State's response to the review team. I have never seen a review in any department of state in which the Secretary of State has said, "This has fallen lamentably short of what I had in mind. I wanted something that was going to address the vandalism and the speculative damage done to British business, etc," which Dr Cable was talking about before he came into government and, indeed, after he came into government—in September 2010. It would be refreshing if at some point the Secretary of State were to say, "This report does not get as deep into the issue as I would like."

What would I like the Secretary of State to do? I would like the Secretary of State to say, "I want a more fundamental understanding of whether public companies are providing a good purpose. I would like to really understand why institutional investors do not seem to regard themselves as owners of businesses. I would like to understand why there are so few people in fund management who have any practical experience of business management. I would like to question whether the idea that fund managers should talk to companies about strategy, organisation and incentive would actually be testing them on issues where they have a competence." Most fund managers have not done anything other than work in the City, in fund management. They have never run a business. I am one of a small group, Chairman, of maybe not more than two dozen people who have had some serious City career experience on both sides of the table. If I were sitting down as the Secretary of State with Professor Kay, those would be the sorts of questions I would be asking. I would say, "John, this is what I really need to find the answer to." The first five or six chapters of John Kay's report are an academic book on market efficiency and agent-principal conflict of interest. It could well be that Professor Kay was not asked questions with sufficient clarity.

Q131 Chair: You talked about being on both sides of the table. Could you just put yourself in our position, and be on our side of the table here? We are doing an inquiry. We want to make recommendations. What sort of recommendations do you think that this Committee should be making to the Government?

Lord Myners: I would almost like you to recommend that the Secretary of State go away and do this exercise again, either with Professor Kay or with somebody else. I would like you to say that there are questions that Kay has only analysed on the surface, and not asked deeply enough.

Chair: That is what Lord Adonis says.

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Lord Myners: If you want to stick to saying, “He is not going to do that, Paul; let us just stick with Kay has produced,” I would pick out three or four things in the Kay report and say, “I want urgency about these. I want urgency about the investment forum and about fiduciary duty. I want to completely look again at the issue of how companies communicate with shareholders.” It would be good if the Secretary of State spelt out in as much detail as possible that his summer 2014 review will be a serious review, rather than a review conducted by officials who would say that everything is broadly alright and that we are going roughly in the direction that Kay set out. He should say, “I am going to staff this up properly.”

I would also come back, Chair, to my point that the Secretary of State could have got a grip on the recommendation about the investor forum. He could have said, “There will be a way found to fund it through a £1-per-deal contract note tax,” which, as I said, goes to pay the fees of the people who are seconded to the Takeover Panel. That would set a good precedent there. If this investor forum is a grouping together of trade associations, it will absolutely support the continuation of the status quo, and will move at the speed of the slowest ship in the convoy. You need an investor forum that combines serious and committed spokespeople on behalf of the ultimate asset owners—the trustees and directors of investment funds—with some people from the corporate side of the table as well.

Q132 Chair: The first problem with another review is that it would be seen as Government indecision. The second thing, of course, is that it could well come up with conclusions that were just as inconclusive as the Kay review. You have outlined some positive steps that we could take as a Committee. It does seem to me that there is a very real dilemma for Government here. It does not want to get in a position of regulating the industry, with huge potential unforeseen consequences, but it has to find a way of making those participants act in a more responsible and long-term manner. I think, generally, there is a consensus about the sorts of principles that should be involved in doing that. Who do you think should be responsible for trying to ensure the compliance of asset managers, asset brokers and company directors? It seems to me that one way of doing this is to have some sort of body that would actually exercise some monitoring influence and, potentially, control over these people.

Lord Myners: If we emphasised the fiduciary responsibility, it would ultimately be a matter for the courts. If trustees or directors were failing, then they would run a risk of challenge from those who have placed them in a position of trust. I look at bodies like the FRC and the new FCA and somehow, Chair, I cannot convince myself that they are going to be able to make much change. The FRC, I think, is in a

comfort blanket of believing that its stewardship code is making any real difference. When you speak to most company chairmen and chief executives—and I speak a lot with those people—they say, “Has the stewardship code changed? Are things fundamentally different and better?” They do not really see any change, but the FRC is able to say 200 fund managers have signed up to it and it is all terribly good. If there were clarity about fiduciary duty, the courts would be the ultimate enforcer.

To just go back to the early part of your question, I do not think it would be a failure or a U-turn for the Secretary of State to say, “Quite frankly, this report has asked lots of questions. Kay set out what the issues are. Where he has not done as well is in coming up with practical solutions. Having identified half a dozen key questions, I want to ask why this is happening and what can be done, and I need another report that comes up with very practical solutions, well rooted in understanding of the real world.” Bear in mind that Professor Kay is a very nice man, but he is an academic. I think the only business experience that he had was when he was on the board of part of what eventually became HBOS. I think, maybe, one might say, “Let’s hand this over now to ladies and gentlemen who have practical and real experience.”

Q133 Chair: I think that concludes our questioning. Can I thank you? It was a longer session than I think we anticipated, but it is also fair to say that it has been more entertaining and illuminating than we perhaps anticipated. You have given us a body of comment and evidence that we may well be able to recycle in our questions to asset managers, Government, and so on. Can I thank you very much for that? I say this to all witnesses, but it is perhaps more appropriate than normal in your case: we may well, on examining your evidence, feel that there are further questions that we would like to ask. We will write to you, and we would be grateful for any reply that you could give. There was, of course, the issue of the Takeover Code and the 28-day “put up or shut up”. If you could provide us with further information on that, that would be very helpful.

Lord Myners: Chairman, may I also thank the Committee for giving me as much time as you have? I am very grateful to you for that. When I read the transcript and the numerous places where I have failed to explain myself clearly, I will write if I think that might help you. I do describe things, Chairman, with a degree of passion. I really do believe very seriously that there are things here that could be a lot better. I would ask your Committee to point us in a direction, bearing in mind the test of: “Will the economy be better?” That is the starting line, and I do not think that Kay has quite met the test. Thank you very much for your time, Chairman, and the Committee

Chair: Thank you.

Tuesday 26 February 2013

Members present:

Mr Adrian Bailey (Chair)

Paul Blomfield
Caroline Dinenage
Julie Elliott
Rebecca Harris

Ann McKechin
Mr Robin Walker
Nadhim Zahawi

Examination of Witnesses

Witnesses: **Catherine Howarth**, Chief Executive Officer, FairPensions, **Christine Berry**, Head of Policy and Research, FairPensions, **Simon Wong**, Visiting Fellow, LSE and Partner, Governance for Owners, and **Dr Paul Woolley**, Head of the Paul Woolley Centre for the Study of Capital Market Dysfunctionalities, gave evidence.

Q134 Chair: Can I welcome you here today? Thank you for agreeing to share your thoughts with the Committee. Can I also apologise for the slight delay in starting? We had quite a lot of urgent business to get through before we started this session, but we will crack on. I know who you are, but for voice transcription purposes could you introduce yourselves and the organisations you represent?

Christine Berry: I am Christine Berry, Head of Policy and Research at FairPensions.

Catherine Howarth: I am Catherine Howarth, Chief Executive of FairPensions.

Simon Wong: I am Simon Wong, a partner at Governance for Owners and I also hold appointments at the London School of Economics and Northwestern University.

Dr Woolley: I am Paul Woolley, a senior fellow at the London School of Economics.

Q135 Chair: I will open the questions. Can I make it clear that some will be person-specific and others will be to the panel? Obviously, that does not preclude anybody from speaking on a question directed at somebody else if they feel they have something to add to or subtract from it. Equally, if somebody else has said what you agree with, do not feel that you have to repeat it. I am conscious that all of you have been prolific contributors to this debate, and we are limited in time, so try to keep your responses as short as possible.

If I can start with a question to Dr Woolley, you have written a lot about the myth of market efficiency. Do you assign the rise of financial intermediaries and institutional shareholders to be a cure for market failure or a cause of it?

Dr Woolley: The main cause is that we have a misunderstanding of how finance works. The prevailing paradigm of market efficiency, which has been with us now for 40-odd years, is deeply misleading. It says, as you know, that prices reflect their fundamental value, that markets are selfstabilising and that competition ensures that agents do not earn excess profits. That has not been apparent for the last 20 years.

Moreover, the theory of efficient markets has informed the actions of everybody to devastating effect. It still informs the actions of investors and intermediaries, but also of the regulators. We know that markets are not efficient, but we are using all the

metrics, analysis and prescriptions of a dud theory, which is only a special and limiting case. What happens is two effects of the fact is that markets are not efficient. I can explain more why they are not efficient, but that will take a bit longer, so I will skip it. The two consequences of inefficiencies are first, that assets are mispriced and we get the potential for bubbles and crashes, and, secondly, that the agents are in a position to capture excess profits. The combination of the two is devastating and has caused the size of the finance sector to balloon and to do its job, which is simply a utility function, very badly.

Q136 Chair: I was going to ask you if you could explain why it is a dud market—I think those are the words you used. I am a bit nervous in view of the time you said it would take to explain it. Could you summarise it in perhaps 40 or 50 words?

Dr Woolley: The efficient market theory assumes that investors invest directly in securities, but they do not; they delegate to agents. The investor does not know if the agent is competent or diligent. That is the heart of the problem, and it is called asymmetric information. The investor does not know these two important facts, and that is the cause of all the problems. What I and my colleagues have been doing for the last several years is providing an alternative framework for analysing markets that presents a general theory rather than a special and limiting case of market efficiency. We assume everybody acts in their own self-interest and in a rational framework—they seek to maximise profits and do the best job as they see it to invest to achieve the best riskadjusted return—and that they are not stupid or do not have behavioural biases. They may do, but the point is that by assuming rationality we can provide an alternative framework that explains all the mispricing. It goes a long way to explaining all the various market failures and phenomena that have not been explained by a theory that assumes that everything is perfect to start with. It is like natural science, where in physics you continue to assume that there is a perfect vacuum or zero friction. You have to relax those assumptions, and that is what we do. We show how it is that markets go wrong. If you can show how they go wrong you can make a good stab at the solutions.

Q137 Chair: I am a layperson in this. Would it be fair to say it presupposes that the investor has the level

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of knowledge and expertise and will act in a rational way, whereas in fact the investor delegates that role to the agent, who may be acting not in the interests of the investor but in the interests of the agent?

Dr Woolley: Who owns the capital? We all, in our private capacity, are the owners of capital. Because we are operating on the basis of a false understanding of how finance works—because theory does inform the general understanding—we have been delegating in the wrong way. That includes the pension funds that act on our behalf, because they are agents as well and have their own interests, as well as the pure agents—the fund managers, brokers and investment banks. But the key to solving the problem is to have a better understanding of how finance works and fails, which involves the simple step that I explained of introducing delegation, and seeing the implications of that. Then we can start to sort things out. We can show those who are responsible for investing the assets of the man in the street how they need to change the way they delegate and the strategies they need to embrace and those they need to ensure are avoided.

Q138 Chair: Do you think that the Kay proposals meet that challenge?

Dr Woolley: No. We have been worrying about the issue of short-termism essentially for 40 years. We have never addressed the problem properly, because we have not got to the key issue. They have all been good descriptions of what goes on and good seat-of-the-pants responses, but you need a new analysis and a new framework for understanding finance. Without that, you will never get anywhere.

Simon Wong: To develop further the discussion on the agency issues and lack of knowledge, regulation equates size with sophistication, so if you manage a pension fund you are considered to be a professional investor, and as a result a certain set of assumptions goes with that. That is quite false. You see that people who are managing these large pools of money are being outmanoeuvred by their agents purely because they do not have the sophistication to understand what they have purchased and what they have been told. There is a big issue there. You see reforms in different parts of the world to try to improve the governance of pension funds and enhance the competence of the people running them, whether they are trustees or people within the pension fund vehicles. The lack of knowledge contributes to the expanding chain of intermediation. You do not know, so you get advice. You might retain other consultants to assist you in your task.

Having said that, I do believe in aggregation vehicles. I do not think we should go back to the days when retail investors made all the decisions. I do not think they are in a better position either. Around the world, in places like Canada and Australia, you see efforts to build scale in pension funds, whether they are defined-contribution or defined-benefit plans. With scale comes greater resources to hire staff and attract people to be governors, and greater access to alternative asset classes, which might be better aligned with the time horizon of pension funds, for example real estate or infrastructure. You might also have greater leverage vis-à-vis your asset managers, so that will bring down

costs. That is just one aspect of the agency issue that it is important to stress.

One other aspect, which may not have been given sufficient attention in the debate, is conflicts of interest. There has been great effort in recent decades to disclose and manage conflicts of interest. We should also stress the importance of avoiding conflicts of interest to start with.

Catherine Howarth: To build on both those sets of remarks, delegation to investment professionals is obviously inevitable in a system of pension savings nationally. What is missing, we feel, is accountability, transparency and opportunities for those whose money is invested by others on their behalf to scrutinise what is done. What is perhaps missing from Kay's recommendations is things that bring the whole debate right back down to the saver whose capital is at risk and who has to trust others in this system. At the moment, there are very few mechanisms for them to access information, for example about how votes have been cast on their behalf. There are very few expectations or practices for pension funds to provide succinct narrative reports about how they have exercised stewardship on behalf of savers, as is expected at the next link down in the chain. Companies are encouraged to provide to shareholders succinct narrative reports on what they do, but agents do not have to provide that kind of quality of succinct information to savers on whose behalf they act. In our system at the moment, there is a big democratic deficit and a big opportunity to begin to overcome some of these agency problems. I certainly do not disagree that we need a new theory of finance, but in practice we need to overcome those problems by making sure savers can hold their agents to account and see what they are doing on their behalf.

Q139 Chair: At our previous hearing, which you may well have followed, Lord Myners commented that technology had impacted on the way the market worked and that we had a transactional-based process. Do you think that in a way that is inevitable, and that the issues you have highlighted hark back to a perceived golden age of democratic accountability and transparency and we will never go back there?

Catherine Howarth: I do not think there has ever been a golden age in this respect. One of the important transitions we are undergoing in pensions is from defined-benefit schemes, where individual savers could sit back and relax because they had a guarantee at the end of the day, to a situation now where they are fully exposed to the investment risk, and it is absolutely essential we have mechanisms to enable scrutiny to take place. Most pension savers are busy and preoccupied with their lives and do not have the time to undertake detailed scrutiny, but, just as in a parliamentary democracy you have a small number of citizens who take the trouble to scrutinise what is done by their representatives, similarly you could have a very small number of people in a workplace pension scheme who undertake that scrutiny and look for reporting from the scheme about how stewardship is being undertaken on their behalf. We do not imagine that everyone is going to get involved in this, but, unless people have rights to information about what is

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done on their behalf, the agents are free to act in any way, and that is a big part of the fundamentally poor health in the system currently.

Q140 Chair: That is an interesting suggestion. I do not want the rest of the panel to comment at length, but broadly, would the other witnesses be in agreement with those comments? Yes, good. Professor Kay did say, “‘The market’ is simply some average of the views of market participants. ‘The market’ knows nothing except what market participants know.” Do you think we have attached too much power to the market, and what has been the consequence? This is a question to the whole panel, and if comments could be kept brief I would welcome that.

Christine Berry: When you say “too much power to the market”, do you mean market participants or the idea of the market as a whole?

Chair: Yes.

Christine Berry: The point Kay makes that companies should concentrate on developing relationships with individual shareholders rather than with ‘the market’ is certainly true. The idea of the share price and the market as the thing around which all the players in the system calibrate their behaviour, even if that is not in the interests of the people who the system is supposed to serve, either the companies or the savers at the end of the chain, is certainly part of the problem. And—in a while I suppose we will come on to our work on fiduciary duty it is also part of the problem with the way intermediaries see their duties.

Simon Wong: The belief that prices in the markets at any particular time are correct, as we have discussed, is ill founded. Yet it infects regulation and contributes to short-termism corporate pension funds worrying about liabilities expanding over short time periods, and executives being perhaps overly concerned about stock price or overly incentivised with share price-based remuneration schemes. Those are a few examples of how it has impacted the market.

Dr Woolley: If I were to point to one major problem about the way markets function and participants act, it is that the greater part of investment now conducted is based on current and recent price movements rather than fundamental value. There are only two basic strategies of investment: trend following—let’s call it momentum investing—and fundamental investing. That is actually the best way of looking at short-termism and long-termism—to understand that short-termism is not just a short holding period, and long-term investment is not just buy and hold. The important distinction is the choice being made between investing on the basis of recent price movements, ignoring value, and fundamental investing, which focuses on the true worth of assets. Unfortunately, because of our misunderstanding of how finance works, the contracts that pension funds are writing with their agents and the way regulators are regulating, vastly more transactions are conducted based simply on recent price movements rather than fundamental value. Very few steps are required to address that problem and rid the markets of so much momentum trading, or automatic trading if you like. The beauty of it is that to do so would be to the great

advantage of pension fund returns and the ultimate beneficiaries. There is a self-interest.

Chair: That is a very lucid explanation, and we will come back to the measures before the end, but I want to bring in Paul Blomfield, who has some questions on Catherine and Christine’s evidence.

Q141 Paul Blomfield: I want to focus on the three mechanisms you suggest to address the principal/agent problem. The first is that you argue for legal mechanisms to be attached to fiduciary duties. What are the minimum fiduciary standards that you think are essential for regulators to enforce?

Christine Berry: It is important to remember that Kay made two different recommendations on fiduciary duty, one of which recognised that fiduciary duties should be part of the solution to dysfunctional capital markets and that they require intermediaries to act in the best and sole interest of the people whose money they manage. The other recommendation recognised that, unfortunately, too often fiduciary duty has been part of the problem and has been interpreted in an unhelpful and narrow way by people who do possess fiduciary duties. Your question relates to the first of those.

The key difference that Simon touched on between fiduciary standards of care and the standards currently applied by, for example, FSA rules or under MIFID, relates to the avoidance of conflicts of interest. As Simon said, we have spent far too much time worrying about the disclosure and management of conflicts of interest. In theory, the starting point for fiduciaries is that conflicts of interest should be avoided altogether and, if they can’t be, they must be resolved solely in the best interests of the beneficiary. Professor Kay himself made a good analogy in an article he wrote for the *FT* drawing on the recent incident involving a ballboy who covered the ball. Kay made the point that he saw there was a clear difference between what would have been fair for him to do and supporting the home team. In the same way, FSA rules currently require that conflicts of interest are managed and resolved fairly as between the firm and the beneficiary, which is clearly different from resolving the conflict always in the best interests of the beneficiary. Those are clearly two different standards. There have been lots of attempts to conflate that in the debate and to say there is no need to talk about fiduciary duty because the regulatory rules already impose those standards. They do not; it is clearly a different standard. The real value of talking about fiduciary duty is in the context of requiring a higher standard in relation to avoiding and managing conflicts.

Chair: That must be the first time ever the activities of a ballboy at a football match have been quoted in evidence in a Select Committee.

Paul Blomfield: But it is a very good way of illustrating the point.

Chair: Yes, it is.

Paul Blomfield: Catherine, did you want to comment?

Catherine Howarth: No, I am fine with that.

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Q142 Paul Blomfield: The further recommendation you make is that the remuneration of fund managers should be structured to encourage long-term behaviour. Are you satisfied that Kay has addressed that? Knowing intermediaries as you do, how would you implement such incentives?

Catherine Howarth: There are huge risks in trying to be too clever with the remuneration of fund managers. We ought to be able to learn the lessons from having tried to be clever around the remuneration of company directors. Simplicity is best. Paul can perhaps speak more about remuneration of fund management. There have not been particularly complex arrangements, but they are creeping in and there is much more performance-related pay now in fund management. That brings a host of risks because, depending on the time frame involved, it will exacerbate the existing compulsion towards short-term trading in the emphasis of fund managers over long-term stewardship orientation. It is an area where pension trustees potentially are a bit naive and could be more engaged.

I also think that fiddling around and trying to bring in sets of remuneration consultants to advise about the ideal theoretical arrangements for pay in the fund management industry could lead us down the same alley where we try to structure corporate pay in a way that is aligned with shareholders to great detriment. It is undoubtedly important, but I do not think it is the main area for recommendation in trying to achieve structural change in the fund management industry. It is far more important to make sure that pension fund trustees as the clients of fund managers are asking smart questions about the stewardship approach that is taken; the engagement that takes place with company directors about the strategy of the company; the long-term risks facing the company, including environmental, social and governance risks. It is important that reporting by fund managers about their stewardship is available down the chain to those savers whose capital is ultimately at risk, who depend upon the trustees to do a good job and who ought to be in a position to keep an eye on the oversight by the trustees of the fund manager stewardship of the underlying companies. Part of the challenge here is that there are lots of links in the chain. That is somewhat inevitable, but bringing it back down to the saver is the critical thing.

Q143 Paul Blomfield: Notwithstanding that caveat, in your evidence you did suggest that a different approach to remuneration could encourage more long-term behaviour. Beyond simplicity, what would you recommend?

Catherine Howarth: There is perhaps a case for ensuring that in the way fund managers are remunerated, there could be some emphasis on putting stewardship, oversight and engagement with companies centre-stage. At the moment, many fund managers regard stewardship activity and engagement with companies, which is a labour-intensive process, as just a cost centre for them, whereas that can in fact be some of the most value-adding process undertaken by fund managers. Trying to make sure that it is very explicit that part of the contract for payment for fund

management includes resources being devoted to that by fund management firms makes a lot of sense for pension fund clients.

Christine Berry: In terms of our taxonomy of ways in which you can address the problem, we talked about remuneration as one of those. On reflection, I would broaden that to call that category “incentives”. Remuneration is one incentive that fund managers are faced with, but it is not the only one. There has been talk in the oral evidence already about the other ways in which pension funds incentivise their asset managers. We gave the example in our written evidence of fund managers who were sacked during the dotcom bubble because they did not invest in tech stocks, so they were underperforming in the short term even though that was clearly a prudent decision in the long term. That is an incentive. Government also provides incentives through the tax system and regulatory regime, so in looking at how we can align incentives better in the chain we should not just fixate on remuneration. There are a range of other relevant tools as well.

Simon Wong: I would certainly second that. I have been speaking to large pension funds around the world as part of research I am conducting. The largest pension funds are looking to streamline their asset manager relationships. They want fewer external asset managers but deeper relationships, so they want to get to know them better and establish a strong basis of trust.

Certain remuneration practices would be helpful, one of which is to have fund managers invest in their own funds so they have skin in the game, so to speak, or to pay fees based on multiple-year performance. I also would like to warn against certain ones. I have seen in passive mandates that the fund manager is rewarded only through the securities lending revenues that they generate. Imagine the misalignment that creates, because that fund manager has much less interest in the value of the fund going up: rather, that person will be more interested in how much securities lending revenue he can generate through that relationship. There are certain things that I would advise against strongly.

Dr Woolley: The key is for the right contracts to be written in terms of the guidelines, benchmarks and risk parameters. Then the remuneration side of it will take care of itself. Once you make sure that fund managers are focusing on fundamental value and are given the appropriate benchmarks, not market-capped weighted benchmarks, and all the risk parameters are sorted, you eliminate most of the momentum trading and the trouble we have with ridiculously high rewards.

Q144 Paul Blomfield: Can I return to Catherine and Christine on the question of consumer pressure? That is another area you focus on, and you say it should have a greater role. You recently wrote in “The Missing Link” about the disconnect between savers and those who manage their money, which is obviously what we are talking about today. How specifically do you think policy makers should address that?

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Catherine Howarth: There are a number of different mechanisms. At a very simple level something we have been advocating for a long time is mandatory disclosure to savers of voting by fund managers who have been delegated those powers by pension funds. I emphasise that most savers are not going to be leafing through the voting disclosure record of their pension fund, but having that information available in the market will allow very valuable opportunities for comparison between funds. It will ensure that fund managers casting those votes know there is a potential to be scrutinised and that interesting controversial votes will be picked up, and that does happen. Some disclosure is going on; it is best practice and is in the stewardship code, but it is very far from the level that would really raise standards across the market as a whole. That is one simple mechanism.

Coming down to the pension fund level, as part of our work at FairPensions we engage a lot with individual pension fund members who are interested in getting answers from their schemes about what is going on and how their money has been invested. They have virtually no rights to information. Some funds do disclose what holdings are held on behalf of the saver and how votes have been cast, but they do not have to. Similarly, although funds are required to disclose whether or not they give account to environmental, social and ethical factors, they do not have to give any account about how that was undertaken, so the opportunity for a fund member to take a view on whether these stewardship functions have been exercised on their behalf diligently and intelligently is extremely limited. Quite small regulatory interventions could be introduced to ensure that information in the market exists and the scrutiny function can be undertaken, which should improve behaviours right through the market.

Q145 Chair: You referred to fairly small regulatory interventions. In a few words could you just summarise what should be done to realise this?

Catherine Howarth: We have long advocated improvements to the disclosure regime for pension funds so they have to give an account of how they exercise stewardship and voting and engagement activity on behalf of scheme members. In the same way that there are calls for company directors to provide succinct narrative reports on forward-looking risks, that is absolutely what pension funds should also be doing for their members. I am a pension trustee and I sit on the board of a scheme that works hard in this regard. Nevertheless, it would focus our minds, and those of pension trustees all over the country, if we knew we had to provide a succinct narrative report detailing the forward-looking risks to the investment portfolios, how they have been managed and what fund managers are doing effectively to manage those risks for the long term. That is where long-termism can start to be hard-wired into the system in a helpful way.

Q146 Paul Blomfield: Can I move on to the stewardship deficit that you have talked about and Simon has written about? Can you describe the

problem as you see it and whether Kay has addressed it?

Simon Wong: I alluded to it in my earlier remarks. It starts at the top of the investment chain. I disagree with the Kay report in the sense that it places excessive reliance on asset managers to drive things forward. The asset owners need to step up in terms of how they monitor the asset managers and the type of investment management agreements they reach with their asset managers. It really starts from that.

There are issues, which I have written about, of whether as an asset manager you have the capacity to monitor properly. If you have a portfolio of hundreds of stocks, can you properly understand each one? My argument would be: no. There is scope to reduce portfolio size in terms of the number of holdings. For example, why would a pension fund need to be invested in 700 companies in the UK alone to feel properly diversified? Academic evidence says that the benefit of diversification tapers off at 20 to 50 stocks, provided they are not all in the same industry, of course. There are issues in terms of being able to monitor companies properly and become a stronger steward.

There is also the issue of skill set. Two weeks ago Lord Myners alluded to the fact that fund managers might not have such a deep understanding of how companies are run. If you are going to engage, do you have the right people with that sort of corporate-type background?

Last, how will they be rewarded for it, or how will the costs be borne? I have written previously that in some funds the costs of engagement are shared between the asset manager and the fund he manages. Those are different aspects that need to be addressed in order to improve stewardship.

Q147 Paul Blomfield: Is there also a question of resources in terms of companies not being prepared to commit sufficiently?

Simon Wong: Exactly. There is the issue of whether you have the right skill set. Do you have the right people who can engage with companies with credibility? Are they sufficiently senior? Do they have a deep enough understanding in terms of what is going on and the complexities of running a business? Presently, people would probably argue that on the institutional investor side you may not have the right personnel in all cases to undertake this type of engagement.

Paul Blomfield: That is helpful. Thank you.

Q148 Mr Walker: One of the Kay recommendations supported by the Government, which was also very strongly supported by Lord Myners in his evidence to us, was the idea of creating an investor forum. FairPensions has been a bit more sceptical about that, saying it is unclear how this initiative will differ from previous and existing investor bodies. Some of the evidence we have just heard suggests that might even entrench some of the problems, with the focus on asset managers talking to themselves rather than necessarily to their shareholders. Would you care to comment on that idea and whether you think that

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could make a difference? Is there a way of setting up an investor forum which could improve the situation?

Christine Berry: There are a few points to make about the investor forum. The first is what it would have to look like in order to be effective. It would need to include representation from asset owners as well as asset managers; it would need to be not just another vehicle dominated and run by the trade associations, which would be very similar to the vehicles we already have. To be fair, that is a view shared by many people who are involved in trying to set up the investor forum. It is not completely clear at this point whether it will ever get off the ground, and that is something worth bearing in mind when making a wider judgment about the extent to which some of the more voluntaristic elements of the Kay package are likely to be successful in the medium term.

It is also important to be clear about the limitations of what an investor forum would and would not resolve. My understanding of the reasoning behind the investor forum and its creation is that it was intended to deal with some of the collective action problems particularly created by the dispersion of ownership, excessive diversification and the fact that any individual shareholder would own only a very small proportion of a company. Clearly, enabling investors to act collectively would be very helpful for that specific problem, but that does not mean it is the silver bullet that will solve some of the underlying structural problems we have talked about in terms of the relationships between asset owners and asset managers, the way those players are incentivised, the excessive diversification that itself leads to this problem in the first place and so on. I hope that is helpful. The investor forum would be useful if it happened in the right way. It will not be the silver bullet that fixes all the problems in the market.

Q149 Mr Walker: Dr Woolley, you talked about the dysfunctionality in the markets. Do you think this would help with that at all?

Dr Woolley: Yes, absolutely. We have to learn the new code of behaviour that needs to be followed. You need a forum to help promulgate this new approach. It is very significant that in the last couple of weeks the G30 has come up with a proposal in its report on long-term finance and economic growth. The first of the five proposals is for a new code of best practice for large funds. That is a huge step. We have never had anything like that proposed. The implication is that currently there is malpractice. It is saying that there should be a new understanding and a new instruction manual. Everybody is using an instruction manual based on this efficient market hypothesis, and we need one that recognises the best benchmarks, risk parameters and contracts with agents. It has to be a complete revolution in the way delegation is handled, and a forum would play a valuable role in educating the asset caretakers. It is not just a UK problem but a global one, and it should be handled globally.

Q150 Mr Walker: Is it not rather optimistic to assume that a forum that is likely to be dominated by the asset caretakers or their trade bodies, as has been

suggested, will come up with a revolution? Is it not more likely to try to entrench the status quo?

Dr Woolley: No. If one rewrites the understanding of finance, one points to the way that funds can in their own self-interest, irrespective of what any other fund does, adopt these strategies and policies. There will be a very significant early mover advantage to funds. If you get the G30 coming up with a code of best practice and some of the sovereign wealth funds and big public funds start adopting this, members of pension schemes in the UK could say to their trustees after a year or two, "Look at the returns you are getting and the returns that the sovereign wealth funds are getting. Why is there a difference?" They can challenge trustees. It replaces a silly herd with a sensible herd.

Q151 Mr Walker: If the forum is structured in the right way. I am interested in the point you make about having asset owners represented in the forum. How do you think that could be achieved?

Catherine Howarth: It is already partly the case that a number of the very largest UK pension funds have staff dedicated to working on stewardship issues—corporate governance experts and so on—so there are resources that they can contribute in terms of personnel or helping to fund the activities of an investor forum. Making sure that asset owners contribute to that would be a very good thing. The point has already been made that to take on a company over a sustained period about a problem you have identified as a shareholder is quite resource-intensive. Given that you own only a very tiny fraction, everyone who owns shares in that company will benefit if you secure an outcome through your engagement and dialogue. It is very sensible to look for a way that asset owners of shares in a given company can share the costs arising from an intensive engagement with a company on a long-term risk. All of that makes sense. It would be really good if we had contributions from individual pension schemes to the costs of running the investor forum. They would then take quite a close interest in what it got up to, and that would be a good thing.

In a way, a trick was missed in the Kay report in not emphasising enough the role of asset owners in taking the initiative on this. There is very strong emphasis on asset managers. The asset managers are critically important agents, and we do need to think about their behaviours, but they are not the ones with the incentives to move this situation along; asset owners are. Asset owners themselves would focus more on the problem if they had to give an account to the underlying members of how they were resolving these issues.

Simon Wong: I completely agree that asset owners need to play a central role. A broader point is that we have a lot of small pension funds in the UK. What do we do? Ontario, for example, has issued a proposal to consolidate asset management to build scale among smaller pension funds. There are steps in that direction that could be extremely helpful. I know this is beyond your remit here.

In terms of the investor forum, it is important for it to have dedicated resources and to come to an agreement

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with existing shareholder bodies that they would perhaps adjust or reduce their activities to avoid unnecessary duplication. That might mean they should be represented in some form in this new forum.

One of the key objectives is to attract the involvement of foreign investors. That is a laudable objective, but we should temper our expectations because of the following: for foreign investors, the UK may be a small market relative to their other holdings, or they may see the UK as relatively well governed and as a result they want to allocate their limited resources to other markets. We should also think about the practices they bring with them. In continental Europe there is probably greater sensitivity to environmental issues and human rights. In the US there is a more permissive stance on executive remuneration. So it is also about the standards that investors bring when they come to this forum.

Q152 Mr Walker: That is very important, and I think colleagues will all want to touch on the issue of foreign investors. I want to touch on one other Kay recommendation around executive incentives. We have talked a lot about the incentives for asset managers and intermediaries. One of the recommendations of Kay was that executive incentives should be provided only in the form of company shares to be held until at least after the executive has retired from the business. There are some concerns about the practicality of that. Do any of you have any views on that idea and suggestion? Is that something on which there could be legislation?

Dr Woolley: No. That is a rather long horizon for an individual. If we have a code of best practice for longterm investors, corporates will start to act in ways that reflect that. They will start to recognise that dividends are the only way the investor gets his money back from investing in shares; they will start to recognise that buying back shares when the price is high is not a sensible thing; they will start to invest for the future and take a longterm view. Just as there should be a code of best practice for investors, similarly there should be a code to show managers what best practice is, not just on research and longterm projects but also on the financial structure and retention ratios to wean them off the short-term focus.

Catherine Howarth: It makes a lot of sense to let the new regime on executive pay that is now going through Parliament bed in. Much more important than further tinkering with executive pay is all the stuff I talked about earlier on which we focused in our report "The Missing Link", which is enabling those at the bottom of the chain who invest the capital, take the risk and delegate to other people to oversee executive pay to have some kind of scrutiny and accountability of what is done in their name. In that area, where there has been very little focus, there are real opportunities to advance the debate. If fund managers know that they are being watched in the way they cast their votes, they will pay more attention, and if they are being explicitly mandated by their pension funds to have conversations and cast votes with an eye to the longterm value of the underlying corporate entity when they are thinking about remuneration, all those

are positive things. Further tinkering in terms of regulation is probably not going to take us forward.

Q153 Rebecca Harris: I want to go back to the governance of pension funds. Mr Wong, you wrote an article saying that it was the missing link in the Kay review. Lord Myners told us of the possibility of resourcing and equipping pension funds as well. What would we need to do, from your experience, to make that happen?

Simon Wong: At present Canada has an interesting proposal, which is to mandate the transfer of assets from smaller pension funds to a new vehicle as a way to build scale. These are defined-benefit plans, so asset allocation decisions will still be made at the pension fund level. But at least you will have a collective vehicle that hopefully will give you better scale and help reduce costs. Where you have decided to retain external managers, it would give you greater leverage. These are steps in terms of how we bring together smaller funds.

A big topic in different countries is who should sit at the top of pension fund organisations. Increasingly, people are coming to the view that the well meaning person on the street is perhaps less and less suitable for this role, and you need senior people with either business or investment expertise because investment has become that much more complicated. Without addressing the quality of the people at the top, both in terms of the trustees but also those in management, you will continue to have problems with an extended chain of ownership, meaning excessive reliance on investment consultants or the use of multiple layers of fund managers either because you do not have access to certain products or you just need advice.

Another benefit of scale is that, instead of just buying products off the shelf, you are in a better position to say, "Can you please design something that would fit my particular needs?" I hope that answers your question.

Q154 Nadhim Zahawi: I have been listening very carefully to the very useful contributions. Dr Woolley talked about eliminating momentum trading and looking at fundamental investing. That is a good point, but, to get rid of the short-termism, on the side of the corporate you go before your investment community at prelims, interims and so on during different periods, and you are judged on that short-term performance. Therefore, that is the driver of human behaviour. Pension fund managers themselves are judged on short-term performance because of their league table. Is not the problem a cultural one in the sense that my parents and their parents have got used to pension returns that are just unachievable? The problem lies there rather than with all the issues around governance. They are all good things, but is there a cultural problem in that we have got used to unrealistic returns on our pensions?

Dr Woolley: Not at all. We enjoyed lush pensions in the 1980s and 1990s for special reasons, mainly because equity and bond markets were so cheap at the beginning of the period, but we can expect a little more than the 1% per annum real that we have had for the last 12 years. It should be possible to earn on

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diversified assets in pension funds more of the order of 3% or 4% per annum real. Part of the reason it is not 3% or 4% real is the cost of the finance sector, which probably amounts to between 1% and 2% per annum real taken off your pension for having it managed—the hedge fund costs, brokers and the whole caboodle. It is also the fact that the way the finance sector is currently structured and its size means it is prone to crisis, and that imposes a huge cost on the economy. As we have seen, in the UK 15% has been knocked off GDP in the last four years. In a steady state, if we get back to global growth of more like 3%, we should look for a return similar to 3% real, but beyond that you should be able to add 1% or 2% on top of that as an expectation. The target that pension funds should aim at is a benchmark of something like real growth of global GDP plus local inflation.

Q155 Nadhim Zahawi: But do the rules of the game allow the pension fund manager the time and the room to say, “I am going to stick with this management team because they are investing for the long term; they may not deliver the returns in this or the next quarter, but I will stick with them”? I do not think the rules of the game allow the pension fund manager that leeway.

Dr Woolley: I agree, given the way the game is played. The point is that, as I said at the outset, we do not understand how finance works, and we have a discredited theory delivering an instruction manual for funds and regulators that causes them to engage in short-termism and all the bad things that are so costly to the ultimate beneficiary.

Chair: What it comes down to is that the purpose of this inquiry is to see where we can change the rules of the game to realise long-termism. Catherine, did you want to respond? If you could keep your remarks brief that would be helpful.

Catherine Howarth: At the moment about 11 million people in the UK are saving through workplace pension schemes. That is about to grow by about 8 million more people through pensions auto-enrolment. We need to get this right, because a very large number of UK citizens are going to be committed through auto-enrolment, often without making a very active choice in that direction, to this system where their hard-earned money will be committed to agents in the hope they will look after it well. While returns in the future—who knows—may not be as juicy as they have been in the past, that is all the more reason to try to get these conflicts of interest in the system ironed out and ensure the beneficiaries get the maximum possible benefit from the system. Good governance, oversight and scrutiny—all the things we have been talking about—are essential components to getting that right. This may lead back to the conversation about fiduciary duty, which is really about trying to make sure that the saver is absolutely at the heart of the system.

Simon Wong: There is a cultural issue. Part of the reason asset managers are obsessed with short-term relative return is that their clients focus on that, but do the clients really understand what they are buying? A UK pension fund trustee admitted to me last year,

“We look at benchmarks because that is the easiest way to measure performance. It is much harder to understand the capability of the asset manager and the strategy being pursued.”

That is where governance needs to change. If you look at the Australian Future Fund, they explicitly stress that they do not look at “peer risk” and how their asset managers perform over the short term. They look at 10-year rolling returns or three-year rolling downside outcomes, so it is a very different way of assessing performance. Some of the larger pension schemes are looking for fewer but deeper asset manager relationships so they can better understand them.

Q156 Rebecca Harris: How do pension funds differ in their structure and governance from other players in the equity market?

Catherine Howarth: There are important differences between trust-based pension schemes, whether they are defined-contribution or defined-benefit, and the insurance side of the pensions market, which has grown rapidly, where individuals have a contract with the firm. One of the issues about which we have concerns is that the standards of protection and the focus on the sole interests of the saver are a bit weaker on the insurance side than the trust-based side of the market. That is one important difference. There are real variations among pension schemes. Some are very big and do their own asset management in-house; they have their own fund managers and hold shares and trade them directly themselves. Most delegate to asset managers so they have various mandates and contracts for equity investing and bond investing and so on. The evidence is that where pension funds take some of that stuff back in-house and manage it themselves, they produce excellent returns and save a lot of costs. One of the reasons they produce good returns is that the costs are lower and high costs eat into returns in a very damaging way. That is a point well made by Kay in his report.

Christine Berry: One of the important differences between trust-based pension schemes and most other players in the chain is that they are generally non-commercial and not-for-profit entities that exist purely to serve the interests of the saver. One thing often forgotten, whether it is in the debate on executive pay or on Kay, is the fact that a lot of the entities we are talking about, whether it be asset management firms, insurance companies or whatever, are themselves listed companies that are subject to all the same pressures we are talking about in relation to listed companies generally. That is why asset owners, particularly large not-for-profit trust-based asset owners with good governance, are the players in the chain who really should get a lot more focus than maybe they have in the debate on the Kay review previously and are the ones with the potential to shift the system. They have more of an incentive and less of a disincentive to shift the system.

Q157 Rebecca Harris: Dr Woolley, to go back to short-termism, clearly we need to extend the period of time over which the performance and the portfolio of individual traders are measured and compensated. You said at the outset that this was an issue that we have

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failed to get to grips with for over 40 years. As the Chairman said earlier, this Committee is trying to get solutions, so can you help me with practical solutions about how we align those incentives as policy makers to make it happen?

Dr Woolley: In a written submission yesterday, I set out seven steps that needed to be taken. To summarise those, it is to educate the asset caretakers. One uses the term “asset owners of the pension fund”. They are not the owners; we are. They are the asset caretakers. We have to educate the asset caretakers to show them that they are pursuing strategies that are causing the returns to be severely reduced. We need to show them the steps they need to take to change to a stable long-term cash flow-based benchmark with risk metrics, and we need to write contracts that focus on long-term performance and, accordingly, fees based only on long-term performance. From the regulator’s point of view, they should recognise that they should not impose these short-term mark-to-market valuations that are coming in. They are trumping every attempt investors might make to be more long-term. If you are focusing just on what the value is in a year’s time you will be forced back into a short-term strategy, so the regulators need to be educated as well.

Q158 Ann McKechin: Professor Kay was quite passionate about the need to abolish quarterly reporting obligations. Dr Woolley, you have mentioned looking at a three to four-year period as the average time over which people should be looking at investments. Do you think that one measure would be of real help, or would people find another way to get back to the same culture we have at the moment?

Dr Woolley: I understood that John Kay was talking about the quarterly reporting of companies. I see no merit in reducing the information flow. The quarterly reporting of pension fund returns should still go on. My concern is that there should be much more focus on long-term cash flows for the investing funds. The point is that, if you focus on doing the best you can each year in terms of the market value of the fund, it will not give you the best outcome in the long run. The long run is not the same as the sum of the intervening short terms. The way of achieving the best long-term results is to invest on a long-term basis, focusing mostly on dividends and interest payments. The whole strategy should shift. Funnily enough, what are called value managers have been doing very well for their clients, and that is a similar sort of approach, which should be adopted.

Q159 Ann McKechin: Does anyone else on the panel have a different view about the issue of quarterly reporting?

Christine Berry: My understanding of your question was whether, if we abolished the regulatory requirement, people would continue to do it anyway. There is an extent to which quarterly reporting and all the dynamics that go with that are driven not just by regulatory requirements but by shareholder expectations. That dynamic is part of the reason we have argued quite strongly—it is something we have not really touched on today—for clarification of investors’ fiduciary duties. There has been a lot of

hand-wringing over the fact that we introduced duties for directors under section 172 of the Companies Act, which were based on the idea of enlightened shareholder value—that directors should look to the long-term success of their company and should consider wider social and environmental factors—but that does not seem to have had a lot of impact. And all the evidence suggests that that is because you cannot have enlightened shareholder value without enlightened shareholders.

Q160 Ann McKechin: Some people say that part of the problem is that it was so vaguely set out in legislation that the ability to enforce it was practically nil. People just felt they could ignore it anyway. We can prepare legislation, but if it is not sufficiently well defined you do not have the ability to enforce it.

Christine Berry: There is an argument around that and I am sure there are respects in which the legislation could have been improved, but the more fundamental problem is that the way the legislation was explicitly formulated was to go not for a stakeholder approach but enlightened shareholder value whereby, because it is ultimately in the interests of the members of the company, to whom directors still owe their fundamental duty, they should take an enlightened approach.

Q161 Ann McKechin: My final question, which all of you can answer, is: do you think that currently we have the right balance between voluntary compliance and statutory legislation? You seem to be suggesting that we need more of the latter. Does the panel think we have the right balance in terms of making these changes?

Christine Berry: On the specific point of fiduciary duty, we have argued that statutory clarification will be needed. That is not to say we need to impose by regulatory fiat good behaviour, but we need to clarify an area of the law where currently it is thought that the law prohibits good behaviour, which is a real problem. That has gone to the Law Commission. We are supportive of that process. We should not assume that at the end of the process it will be sufficient just for the Law Commission to pronounce, “This is what we think the law is”, and it will change behaviour. That would be hugely helpful, but I am sceptical whether it will be enough. There will be a need for express clarification.

More generally, there is certainly a case to say that there is too much focus on voluntarism at the moment. Kay makes the point, which I think is correct, that you cannot impose regulation to make all these cultural changes, but that does not mean there is nothing Government can do. One of the things Kay says Government can do is set the tone, and one of the ways of doing that is by articulating a willingness to regulate if voluntarism does not work.

Simon Wong: On your last question, I am going to sound like a broken record, but the Government can facilitate the consolidation of pension funds by establishing pooled vehicles and compelling transfer of assets and, correspondingly, providing liability protection to trustees in that respect, which is being proposed in Canada. There might also be scope for

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regulatory intervention in terms of avoiding conflicts of interest. The last thing is the tax regime. People have talked about perhaps lowering capital gains tax if you hold shares for the longer term, but maybe you also want to take away their ability to write off losses in certain respects for short-term trading and so on. There is scope there.

Chair: That concludes our questions. I realise that we have had to hurry you to a certain extent; indeed, we have had to hurry ourselves. If there is further

evidence you would like to give to the questions you have been asked, or questions that have not been asked but you feel should have been, please feel free to write to the Committee to submit that. Similarly, if we feel that there is a question we should have asked arising out of the evidence you have given us we will write to you and will be grateful for your courtesy in replying. Thanks very much indeed. I am sorry we have had to hurry you a bit.

Examination of Witnesses

Witnesses: **Dominic Rossi**, Global Chief Investment Officer, Fidelity Worldwide, **Anne Richards**, Global Chief Investment Officer, Aberdeen Asset Management, **Harlan Zimmerman**, Senior Partner, Cevian Capital, and **Roger Gray**, Chief Investment Officer, Universities Superannuation Scheme, gave evidence.

Q162 Chair: Good morning and welcome to the inquiry. Thank you for agreeing to give evidence to us. I do understand, Harlan, that you have a problem with your throat. We appreciate your fortitude in coming before a Select Committee and trying to speak to us, but if it does become a problem, feel free to back out of this session and we will rearrange for you to address the Committee at a future date. I would stress that we do want to get full value from your contribution today and if you have physical impediments to giving us that then it will be better to leave it to another day.

Can I just ask you to introduce yourselves and the organisations that you represent, just for voice transcription purposes?

Roger Gray: I am Roger Gray. I am the Chief Investment Officer for USS. My title actually goes Chief Executive Officer of USS Investment Management Limited.

Chair: That is the Universities Superannuation Scheme.

Roger Gray: Correct, which is the pension fund for the university sector for primarily the academic staff. There are about 300,000 members and about £36 billion; it is the second largest pension fund. Relative to the previous discussion, we are in that rare category in the UK of being large enough to have a large inhouse investment team and therefore a significantly reduced proportion of intermediation.

Anne Richards: I am Anne Richards, the Global Chief Investment Officer of Aberdeen Asset Management. We are a listed company on the London Stock Exchange. We manage around about just shy of £200 billion for external clients, which will be a mixture of pension funds, institutions and private retail investors, both in the UK and a considerable proportion of our clients are overseas.

Dominic Rossi: I am Dominic Rossi, the Global Chief Investment Officer of Fidelity Worldwide Investments. We manage approximately \$300 billion, of which about \$175 billion is invested in equity markets around the world.

Harlan Zimmerman: I am Harlan. This may not work, because of my throat—it sounds a bit like garbage collection testimony in New York. It sounds much worse than it feels. I will leave it to you whether we should continue. I am Harlan Zimmerman, Senior

Partner, Cevian Capital, which is the largest dedicated active ownership investor in Europe. We are long-only. We have only approximately 10 to 12 companies at a time. The average holding period is four to five years. We manage about €7 billion.

Q163 Chair: Thanks very much. I would reiterate if you do feel that you cannot speak anymore, feel free to back out and we will arrange for you to come again. I have a couple of opening questions. This is to Roger Gray. You included a copy of the letter that you sent to Professor Kay during his review. Why was that and did you feel that you had not had adequate consultation with him? Do you feel that the concerns that you expressed have been addressed by Professor Kay?

Roger Gray: That is quite a wide open question. Ours is one voice. We believe that, as an end investor, that voice probably had some standing and indeed is generally heard in the market. It is not universally held, so no umbrage if not all of our views are incorporated in his conclusions, but I would say that the letter is there as much to show that we are actively engaged, as an end investor, with any consultations to do with the workings of the financial system and how it plays to the interests of long-term investors.

Q164 Chair: Do you feel that organisations were sufficiently consulted by Professor Kay?

Roger Gray: It was a tough ask, and one of the reflections on the nature of the pensions industry in the UK is that there are not very many of us who have the dedicated resource to respond to inquiries such as this. We have a team of five professionals in responsible investment. There are a handful of other funds that have one or two individuals so dedicated, and then it runs out. So if the voice of pension funds has not been heard through us or through the trade organisation, then that is as much a reflection of the structure of our industry as it is on the endeavour that he undertook.

Q165 Chair: That is an interesting observation because, from my perspective as, obviously, a contributor to pension funds, it is a bit worrying that there are, shall we say, inadequate resources in the

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industry to respond constructively and positively to the inquiry. Is that a fair reflection of what you said?

Roger Gray: That is a fair reflection, yes. There is a high degree of fragmentation in the UK. There are certain markets in Holland, Canada or Australia where there is more concentration and you have a stronger representation of that pension fund group in the ownership of domestic stocks and somewhat different governance arrangements arising from that.

Q166 Chair: You also said to Professor Kay that “there are likely to be different solutions to the agreed problems.” Now, given the fact that we are trying to hold an inquiry to come to an agreed solution to agreed problems, what exactly did you mean by that? In effect, what would your solution be to what I think are generally agreed as the problems?

Roger Gray: I do not think there is a magic bullet and I do not think there is one clear regulatory or legislative solution to this. It is going to be built up from a number of contributions. This inquiry, the Kay inquiry, the Stewardship Code, the increased attention to corporate governance and the responsible investment more generally that has built up post the financial crisis are all good stuff pushing in the right direction. The question is: will it actually help, or will there be unintended consequences if one pursues with too much emphasis any one of these tracks? I would encourage a broader front rather than a single silver bullet, which I do not believe exists.

Chair: I am now going to hand over to Julie Elliott to ask some questions of the whole panel. I would emphasise that there is no need for every member of the panel to contribute an answer if it does not add significantly to, or indeed subtract from, what a previous speaker has said.

Q167 Julie Elliott: I think that means keep it short. Ten years ago, 15.3% of UK shares were held by individuals. In 2010, that figure had fallen to 11.5%. In your opinion, what are the reasons for this continued rise in institutional investment?

Dominic Rossi: The first point is obviously that equity markets have not performed very well, and in any market that has disappointed with its returns the activity of the individual investor is likely to fall. Subsequently, I do think that if equity markets were going to recover you would see an increase in that participation. But obviously is it likely to be just that factor? I suspect not. I suspect that the intermediation structure that we have and that has grown over the course of the last 10 years or so is part of the reason as well.

Anne Richards: I would add that people have been working in an environment where they have been saving less and borrowing more, and it is a net effect from that. If you are borrowing a mortgage to buy a house, you have choices. You do not just have the option of putting your money into the equity market. You can put it into property and other sorts of assets. In a world where people have been tending to direct more of their savings towards building property, one of the consequences of that is that they put less into equity markets. That is also a factor.

Harlan Zimmerman: The other factor is there has been an obvious breach of trust. It would be difficult to pick up a *Financial Times* today and not find an article about an august British listed company for which the man on the street would think, “What are these people doing with my money? Paying themselves too much, playing with LIBOR, buying companies here and there, paying billions of dollars of fines in America for all sorts of institutionalised schemes that have been found to be corrupt.” If you are the average man or woman on the street, it is quite obvious that you would begin to consider whether these sorts of institutions can be trusted with your money.

Q168 Julie Elliott: With the increasing presence and responsibility in the equity market, have you perceived any strengthening in the regulation of institutional investors?

Anne Richards: If you look at regulation and how it has evolved over the last 10 years or so, there have been some things that have worked well and some things that have not worked well. The things that have worked well have been around principle-based regulation. It came under some pressure for failing to prevent some of the flaws in 2008 in the financial sector, so it is not a solution to everything. But look at some of the things that I think have worked very well—I would draw your attention, for example, to the treating customers fairly regime. It is not prescriptive in the detailed implementation of rules and regulations around treating customers fairly, but the concept is easily understood. It has forced all of us in the investment management world to take a step back; for every action and step along the way, whether we are dealing in the institutional or in the retail space, which is quasi-institutional, it has given us a very good and timely reminder to consider the effect of any action we are contemplating on continuing, exiting and new customers. I speak for our own business, and that is probably true generally across the industry. That is now a very well embedded concept and it has worked well.

Where regulation has not worked well is when it has drilled down into detailed complexity and attempted to, in a sense, micromanage some aspects of the market. In fact, increasing that complexity has made the market—and I use “the market” in its broadest sense—more difficult to gain transparency on and more difficult to manage. As an example of that, I would say the increasing requirement upon many of the agents in the food chain themselves to seek external advice has dramatically increased the number of agents in the chain and has not ended up with us having a better and more effective chain. For example, for the individual who is now required to take advice from an independent financial adviser on their pension fund, the pension fund takes advice from actuarial consultants and investment consultants. They have their asset managers who then manage the money on their behalf. We invest in companies who, in order to get the remuneration reports right, use remuneration consultants and so on and so on and so on. That is an example of where an attempt to micromanage has not

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ended up with a more robust regulatory regime, even though the rules are many times more prescriptive.

Dominic Rossi: The question offers the opportunity to endorse one of the comments on regulation that Professor Kay makes in his report. This is that, with the question of stewardship and the desire to encourage asset managers like Fidelity to engage with companies on board appointments, major investments, acquisitions and so on, that engagement comes head to head against a regulator and a market abuse regime that insists upon uniform information. Within Kay we have an agenda that is entirely different from the one that the FCA is currently pursuing around market abuse. At some stage, we are going to have to triangulate this conversation and include the FSA, because they are trying to sterilise the dialogue between professional asset managers and the companies in which we invest.

Q169 Julie Elliott: How do you—and, indeed, do you—think the UK benefits from the growth of institutional investors?

Dominic Rossi: In the UK alone, we employ 40 analysts and 30 fund managers to scrutinise companies, their management and their corporate strategies before we make an investment. I do not think that would have been possible without the institutionalisation of our industry. Not all asset managers will do this, but we have a very effective corporate governance team that genuinely works with the companies in which we invest to improve their performance and to monitor and, if necessary, redirect their own management incentives. If you consider that asset management has a dual mission—which we do, and I think that is one of the most important conclusions that Kay comes to—first the fiduciary duties to our clients to maximise their returns, but also the stewardship responsibility of improving corporate performance, without the resources of an institutional organisation you would not be able to perform those two. That is not to say that all institutions do perform those two missions, but if you did not have an institutional framework I do not think it would be possible.

Anne Richards: It comes back to the point that was raised in the first session about the information asymmetry. It is not just an information asymmetry but a skill asymmetry between somebody whose day job is quite different, trying to decide, as an individual, whether they think that is an appropriate individual investment or an appropriately risk-adjusted portfolio in which to invest, and the economies of scale, as Dominic has said, that you can gain from a lot of heads who are effectively looking at a particular issue, company or group of companies day in, day out. They can glean much more information from the mass and morass of information that is out there. There are benefits to it in helping bridge that information and skill asymmetry gap.

Roger Gray: I do not know if I should drop this point in, but of course one of the big changes is that the pension fund industry, the insurance industry, in the UK is no longer such a prominent investor in UK equities as it once was. That has to do with the derisking that has taken place and is partly to do with

demographics; obviously in the pension fund industry a lot of defined-benefit pension funds have closed and have matured, which means that they have to take low-risk portfolios. So it is rather stark: where else do you look? We can play a significant role still as investors, but just speaking about my own fund, in the mid-2000s about 40% of the fund would have been in UK equities. That is now about 16% of the fund. Part of that is that we have globalised and diversified our fund, but the institutions that are investing in the UK equity market are now far more diverse in terms of their origin than they were. So the UK-held portion of the UK equity market is much reduced, not just in the retail space, which you alluded to at the beginning of this question, but also in the UK institutional space. If I just choose an asset manager, BlackRock has \$3 billion under management [*Interruption.*] Yes, sorry, \$3 trillion—it's like Austin Powers, isn't it? That is more than the entire UK pension fund industry, of which only a portion and now a much reduced portion is in UK equities.

Q170 Chair: A couple of questions have arisen out of the answers to that one. First of all, Anne, earlier you mentioned that Government are trying to introduce regulation to the detail rather than the broad principle, and you gave an example. What could the Government have done to realise the objectives of their regulation but without having to regulate to the detail that they did? Have you any observations on that?

Anne Richards: The first thing to point out is that it is not all Government-induced. Part of it is regulatory-induced. In part, it is to do with perhaps not joining the dots. It is a fragmented approach rather than perhaps starting from a unifying vision and then working out how that can be taken down. When I talk about a fragmented approach, the sorts of things that I would put into that category are perhaps along the lines of taxation for different types of instruments, which has an effect on behaviour in the markets, and how that taxation is dealt with alongside the pensions regime or the broader savings regime.

One of the things that Government can do to bring about a greater effective change is, for example, by adopting a cross-party and longer-term approach to the overarching operation of the savings and pension regime right across the spectrum. You take away the annual tinkering, for example, that goes on around the rules and regulations of individual savings and pension products. We still have a very fragmented approach in that regard. At a very practical level, moving the savings regime out of the political football to the greatest extent possible, and bringing about a more broadly based and a longer-term vision as to how we might then tackle some of the individual problems that have arisen underneath that, would be a very good starting point.

Q171 Chair: Perhaps this Committee will make a contribution to that process. Roger, there is a particular question I wanted to ask you. You talked about the steps taken to derisk pension funds and take them out of equities into gilts, bonds, etc. Do you feel that, if there had been a better regulatory environment

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that concentrated on long-termism, the need for doing that and the consequential reduction in returns that we had arising from that move would have been avoided?

Roger Gray: Yes. Paul Woolley was referring to some ways in which one could assess whether a long-term investor was indeed doing all right relative to their long-term liabilities. He was saying to look at their income generation capacity, for example, not just the mark-to-market movement in price, and that is an important consideration. Movements in the direction of allowing pension funds to look very carefully at “these are our assets, these are our liabilities; we believe that we are doing all right against them, although the markets do not necessarily agree with that on a snapshot basis” seem to me to be an important dimension of flexibility to get into the system.

All that having been said, the world is a very complicated place and there is real risk out there. The reason why pension funds are suffering at the moment is because there was indeed a financial crisis, and five years have passed and we are still suffering from that in terms of economic progress. Changing cannot get rid of the fact that the pension fund must look after paying its liabilities. Indeed, as I say, there are lots of good reasons why pension funds have derisked; they are not just regulatory ones, but probably at the margin some of the regulatory practices have conduced, or would in future conduce, to behaviours that are not optimal for the long term.

Q172 Julie Elliott: Professor Kay told us that companies tend to finance investment through debt and retained earnings rather than from equity markets. Do you agree with that?

Dominic Rossi: Obviously, over the course of the last 15 years the cost of debt has fallen significantly relative to the cost of equity, which has risen. So if you are a company and you are looking to finance an expansion or an acquisition, debt is going to look like a much cheaper option than equity. On top of that, one has to recognise that the tax code acts as a subsidy through the P and L statement from equity owners to debt. So you have a tax system that incentivises the accumulation and creation of debt as opposed to the creation and accumulation of equity, and then you end up with a financial crisis.

Julie Elliott: That sounded so simple.

Anne Richards: When I started looking at UK equity markets a little over 20 years ago when I started running money, there were close to 1,000 companies in the FTSE All-Share Index and now there are just over 600; the number of companies listed in the All-Share Index has fallen markedly. As asset managers, a lot of us would have sympathy with the view that Professor Kay talked about in his report, which is that the primary function of equity markets is evolving. They are no longer the sources of primary capital. They have become largely the transaction of secondary holdings, and that is their primary purpose. That is quite interesting.

I think the taxation point is an excellent one and I completely agree with that. There is an unequal treatment.

Q173 Julie Elliott: You have really answered this, but does anyone else have any comments? What do you regard as being your primary role in the market?

Dominic Rossi: Also governance. Some companies are publicly quoted in order to protect themselves from regulators, because it gives that check and balance to regulatory involvement. It is not a common answer to the question, but certainly if you ask companies—defence contractors, for example—one of the reasons they are publicly quoted is because they think that the public market gives them some protection.

Roger Gray: Before this Committee, it would be important to say the equity market does some good things. Amidst the noise of the pricing of stocks it does identify winners and losers, and while not always getting it right—who does, particularly when it concerns the future?—that is one of its purposes. Of course, in this context it also gives an avenue for the influence of the owners of that business in terms of the long-term strategy, remuneration and other policies where we think it is important to get the right balance between the end owners and the executive and board.

Anne Richards: We are allocators of capital. In our business that is how we view ourselves. In the UK, our typical portfolio will have between 40 and 50 names in it and our average holding period will be upwards of five years; it is usually seven, eight or nine years. So we regard ourselves as allocators of capital. What we are looking at is where we can allocate capital on behalf of our clients to get the best and most robust long-run return out of that. It incorporates what Dominic talks about in terms of governance. That is a very important part. We do not, for example, have a separate corporate governance team or stewardship team that sits on the side. Our fund managers are responsible for all engagement with the companies in which we are investing, because if we are going to allocate capital to an industry, to a business for a long period of time we want to make sure that we trust the management team to look after that capital appropriately. There is very much that broad allocator of capital view in our role, and Aberdeen is not unique in that. There are other companies that will very much articulate in a similar way.

Q174 Julie Elliott: Lord Myners recently described his report from 10 years ago as a call for action, and Professor Kay closes his report by saying that the task will be long and difficult, but it is time to begin. What will success look like and how do you see the equity market in 10 years from now?

Dominic Rossi: Shall I try to answer that?

Chair: If you can keep it fairly succinct.

Dominic Rossi: Professor Kay’s report was one of the best that I have read on our industry in 25 years. It has been criticised because the recommendations seem relatively light compared to the analysis, but if you ask an academic to produce a report it is going to be an academic report. The analysis that he has put into the industry from a non-practitioner is undoubtedly sound. Where we will hopefully make progress over the course of the next 10 years—and we

do need to make progress—is on the three key issues that he raises. The first is stewardship. Too many asset managers, as I have said already, view their responsibility solely to be that of investment performance rather than also improving the performance of the companies in which they invest. The industry could make huge progress in that role and one way of strengthening that dual mission is to get the regulator to recognise that we, as asset managers, have a dual mission. In all my conversations with the FSA over many, many years they have never asked me once what I am doing to improve the performance of the companies in which I invest. That is the first thing I would suggest.

The second thing is around the whole issue of shorttermism. Everything that you have read around the culture of short-termism is indeed correct. One of the challenges that we, as asset managers, face with respect to short-termism is the persistency of our clients. It is an industrywide problem, but I think the proliferation of intermediation has shortened the persistency of clients in our industry. This means that fund managers are under pressure to perform within a two or three-year time period.

Asset managers used to market directly to the end client 30 years ago, but tend not to today; we have lost contact with the client. By asset managers getting closer to the end client and strengthening our direct relationships with the end client we will improve persistency of assets, and that will have a spin-off in terms of the investment time period.

The third key area is the one of remuneration. I am on record as saying many times that corporate remuneration is too complex and too shortterm. That is also true of the asset management industry. The asset management industry will not be treated seriously in boardrooms until it extends the duration of its own compensation schemes, and we fully endorse the recommendations of Professor Kay on that particular issue.

If we pursue those three issues, I think we will be in a far better place in 10 years' time than we are today.

Anne Richards: It is about trust restored. Success will be that the person in the street has regained trust in the savings and investment industries in general. That trust has been lost to a large degree. I agree with what Dominic has said. I would also add that a focus on outcome rather than process is an important part of rebuilding that trust.

Q175 Julie Elliott: Dominic, you have alluded to the supplementary on this question but I will ask it in case anyone else wants to add. It has been reported that the European Securities and Markets Authority has laid out reform to fund managers' pay. They said that deferred bonuses should be paid out over a three to five-year period, with firms encouraged to consider even longer delays for members of management. The FSA will be consulting on this. How should such a reform be implemented to ensure maximum effect?

Dominic Rossi: Our own view on this is very clear: we should strengthen equity ownership, and the vesting period and the holding period of that equity ownership should be a minimum of five years. Our own scheme is career shares. We own shares in our

company that we cannot sell until we retire. That might be too much of a mouthful for some in our industry, but I genuinely think that long-term equity accumulation really does lend itself to longer-term thinking. I think Kay is absolutely right on that matter.

Q176 Julie Elliott: Would everybody else agree with that?

Roger Gray: It is clearly a balance. Paul Woolley mentioned this previously and I will just repeat it. Someone who is working may have a mortgage and a family and may therefore want to reap some of the reward from what they are doing, and it is about what is the weight that you put on the longterm incentive. A comment on the industry. First, internally we focus on five-year rolling average returns and then we defer some of the bonuses that arise out of that for a further three years. I would call that relatively long term. We do not have shares in our own company; we are not set up for that. One of my comments about the industry at large is that we have sought to engage managers with longterm incentive arrangements, and we have been relatively unsuccessful in achieving that. Particularly in the hedge fund domain, where we thought some humble pie would have been consumed sufficiently to shift that dial, it has been an almost hopeless exercise.

Anne Richards: In the spirit of longer-term compensation I think the direction is absolutely right. One of the things that we are somewhat resistant to is the idea that compensation should be linked in a formulaic way to individual investment performance. I have seen this many times over the years and there is no doubt that behaviour follows incentives, so you have to be absolutely crystal clear what incentives you are putting in place. The approach that we have taken in our business is that the primary incentives we are putting in place are the behaviours that we want. We focus on certain things that are important to us and stewardship plays a part in that and longer-term investment performance is also a part of that, but we are resistant to the idea of making it very formulaically driven because then you start to get investment decisions being driven by the compensation rather than as a reward for it. It is important to make sure that it is a balanced scorecard approach, not just a simple numerical formulaic approach to delivering compensation.

Q177 Ann McKechin: I will turn to the impact of foreign investors and to you, Dominic. Professor Kay's report mentioned the fact that foreign investors, in his opinion, were reluctant to involve themselves in the governance and strategy of UK companies. He did list Fidelity as among the American firms to which he was referring. Has he understood the structure and global nature of you and other international businesses?

Dominic Rossi: I certainly read Professor Kay's comments. I also note that Paul Myners mentioned Fidelity in a completely different light, I am glad to say. I agree with Kay on the issue of stewardship. I also agree with him that the asset management industry is committed to stewardship to varying levels of degree and that this creates a free-rider problem,

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but I completely distance myself from Professor Kay when he wraps the stewardship issue up in a Union Jack. I do not think it is a matter of nationality. I think it is a matter of attitude. The question that all asset managers need to face is: do they believe that part of their role is to improve the performance of the companies in which they invest? We certainly do and we are resourced in order that we can fulfil those obligations.

Q178 Ann McKechin: Can I just clarify one point with you? Are the shares managed by Fidelity classed as UK-owned or foreign-owned?

Dominic Rossi: I remember that question. They will be classified as UK-owned.

Q179 Ann McKechin: That is very helpful. Can I ask all the panel now, in your experience, are Professor Kay's comments and his analysis of the issue of foreign investors in general correct? Obviously, I take Dominic's point about Fidelity, but do you think that there is a growing issue about foreign investment?

Harlan Zimmerman: There is a general issue that proper stewardship and engagement is a cost centre for most investors. There are some exceptions sitting on the panel here, but for most investors that is the case. You do the minimum that you can to protect your investments, which is much less costly than getting involved in 6,000 companies. You focus only on the greatest transgressions and react in a defensive way, and you do the minimum that society imposes upon you. For many foreign investors who do not have the societal pressure here, it is much easier just to vote and do no more. I have been in the asset management industry here in the UK for 20 years or so, back when even the UK institutions often did not vote. Then it became voting with management, if you wanted—you had to vote but you really should vote with management. If you did not want to do that, it had to go all the way up to the top of the organisation. Then it became voting in an educated way, which meant using proxy advisers. We are slightly evolving beyond that, but too many institutions are able to hide behind that and say that because they are voting that is stewardship; because they are writing letters to 14,000 companies around the world that is stewardship. In fact, that is the least costly way of doing something that will protect you from the societal pressures etc.

Q180 Ann McKechin: So it is really more to do with the fact that these companies are global conglomerates rather than being just simply foreign owned, because the vast scale of their business is such that they are not interested in a more direct approach with a company's investors.

Harlan Zimmerman: Do you mean the asset managers?

Ann McKechin: Yes.

Harlan Zimmerman: It is just a numbers game. I would say USS is about the best that exists in the UK, from our perspective, of an engaged owner. If you look even at the numbers there—and it is just five people, I think Roger said—the people there are very

good, but how many companies do they have to look after? There is only a certain amount that can be done, which is why there is all this discussion of trying to outsource this work to the investor forum or something of that nature. Then, as most of you know, and we may come back to this, our point of view is that we are already paying 1,000 people or so in the FTSE 100 to whom we are outsourcing stewardship on our behalf, and those are the nonexecutive directors of the companies. It is they who often do not seem to be doing the job on our behalf.

Ann McKechin: I wonder whether Roger or Anne have any comments on this issue.

Roger Gray: I would like to pick up on that flattering accolade in the air and also accept the point that it is the art of the possible. There are limited resources, and in fact a definition of hell would probably involve all fund managers being hyperactive with all company boards and management, because there are other things to do than dealing with that. Clearly, we all must look to be effective rather than encumbering the companies we invest in or, indeed, snarling up all our resources doing something, so there is a judgment to be made. We vote 92% of the shares that we own, and 100% in the UK. We engage in some close engagements with companies, but I would say the UK will be a larger proportion of those. Our holdings are bigger in the UK and therefore there is more money behind it. We do participate, where it is available to us, with services or groupings such as Eumedion in Holland, which reflect our institutional—

Q181 Ann McKechin: Do you think it is sensible that when a UK company gets beyond a certain critical mass of shareholders who are foreign shareholders there is an impact on the degree of engagement? There has obviously been an increasing shareholding in UK companies held by foreign companies. Has that had an adverse or neutral impact, in your opinion?

Roger Gray: There are forces moving in different directions. The passive industry has grown and it is definitely debatable to what extent they have interest in deploying a lot of resource in terms of active engagement. The concentration of the asset managers, the active ones, does mean that even while the shares of companies are owned by the foreigners, the share register is not getting less concentrated if you look at the asset manager status. I am afraid I do not have a perspective on whether there is a big tectonic shift. We do know that the UK institutional investor voice, the end owner such as ourselves, is somewhat less strong in terms of its ownership stakes than it was.

Anne Richards: I would just add onto that, I see this from both sides of the table because I am an Executive Director of Aberdeen and I do spend time with our shareholders as well. We have quite a significant overseas shareholder base in our own share register and it is difficult to generalise. There are some overseas investors who are extremely engaged, so it is quite variable. What I would say, as it was a very good point that Harlan made, is that we do, to a degree, outsource part of this to non-executive directors. They are there to guard stakeholder interests, and shareholder interests most particularly

within that. One of the more encouraging things that has come up in the last three to four years is that we are definitely seeing much more proactive engagement from chairmen, in particular, chairmen of remuneration committees, coming to us in advance of renegotiating executive pay, appointments of new executive directors, and so on and so forth, having that dialogue in advance of something becoming a controversial issue, and saying, "What do you consider are the key things that we should be looking at and building in?" That is an encouraging trend and we should do more to encourage even more of those non-executive directors to step up to the plate and do that. That is not just necessarily with UK-based investors; that can also be overseas investors, so that is a really important mechanism in this.

Q182 Nadhim Zahawi: Roger has told us about the percentage of his business that is UKbased, but Professor Kay reports that owners of more than 40% of UK shares are based outside of the UK now. What proportion of your clients is based in the UK?

Anne Richards: Just over a quarter of our clients are UK-based clients. I think the number is about 27%, give or take. The rest will be overseas.

Dominic Rossi: I think we would be slightly less in terms of our UK client base, given the fact that we have large businesses in Asia and particularly in Japan.

Harlan Zimmerman: In our case, almost none. So that we can make longterm investments, we require a threeyear lock-up from our investors. Most institutional investors in the UK are not comfortable with that, investing in listed equities.

Q183 Nadhim Zahawi: What proportion of your funds is made up of UK companies, and what proportion is foreign companies?

Anne Richards: For us, a little less than 10% of our total assets under management will be invested in the UK stock market.

Dominic Rossi: Coincidentally, ours is about the same level.

Harlan Zimmerman: We have 12 investments in total; four of them are UK companies in which we own between roughly 7% and 20%. These are FTSE 100 and 250 companies.

Q184 Nadhim Zahawi: I do not know whether you can help me with this question, but in terms of voting, do you tend to take more or less interest in your UK companies versus your foreign-owned companies? Dominic, I think you addressed that by saying it is a cultural thing inside the business.

Anne Richards: For us it is right across the board. We have the same level, the same aim to attend AGMs where we think it is particularly important to do it. We aim to vote all of our shares unless there is a share-blocking mechanism. So it is absolutely the same. We have a unified process.

Dominic Rossi: The issues you face are very, very different. In the UK, much of our engagement with companies revolves around nonexecutive appointments to boards and management incentives. In Indonesia, you do not get asked about management

incentives, curiously; it is more about just trying to assert your rights as minorities. So you have to alter the agenda depending upon the environment you are working in, obviously.

Q185 Nadhim Zahawi: How are the roles of the fund management and corporate governance management administered within your institutions? How is it split?

Dominic Rossi: We have a separate corporate governance team, although I should add that they work very closely with the fund managers. We have a separate corporate governance team for two reasons. First of all, particularly in the area of management incentive and remuneration, it is quite a complex issue and we think it requires a specialist expertise. Secondly—and this is particularly important—it is around pricesensitive information. By having a corporate governance team we can be brought over the wall by a company much, much earlier on than we otherwise would be if that information went directly to our fund managers. Therefore, we can split the two off when we need to create a Chinese wall. It enables our fund managers to continue managing their portfolios, yet we can get involved in the appointment of an executive chairman or non-executive chairman and so on. So the separation fulfils two particular issues.

Anne Richards: We have the completely contrasting approach, which, as I have already mentioned, is very much to embed corporate governance within the fund management team. Perhaps for us that is more manageable given that we have the single unified investment process, our active holdings in the UK are a relatively short list and we expect our fund managers to be able to drill down deeply into it, and because we do not trade them very frequently. It is a different model.

Roger Gray: We have separate responsible investment and fund management teams—separate by five yards. The expectation is that fund managers who are taking the final decision to invest in a company will have incorporated the environmental, social and governance considerations into their decisions.

Harlan Zimmerman: Our strategy is specifically to invest in companies and try to make them better listed companies. Therefore, all of us are focused on the governance as well as the investment. The route to making them better normally is, in part, improving the governance, because that filters down into the areas of operational underperformance, bad strategic decisions, bad capital allocation decisions and so on. So, for us, it must be integrated.

Q186 Nadhim Zahawi: We have integrated, five yards and total separation. My supplementary to you is: what happens when a corporate governance manager votes in a way that will be detrimental to the shortterm share price? Where is the separation? Where is the wall? Take, for example, voting down the remuneration of the chief executive.

Dominic Rossi: We have a set of remuneration policies. The voting team will vote in accordance with those policies. To be honest, that covers 90-odd per cent. of situations, but you are right. There are

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instances where it is not possible. A classic will be where we have a takeover situation and we own both sets of shares. How do you marry that problem up? Those issues will often come to me to resolve one way or another.

Nadhim Zahawi: Presumably, if it is totally integrated—

Anne Richards: You would not get a situation where there was a disagreement, because we would come to—

Nadhim Zahawi: You would sell the shares, presumably, if you are voting down something that you do not like.

Anne Richards: We will tolerate short-term underperformance if we think that the longer-term goal is worth that price. If we think it is something where we have engaged with the company, they still do something that we dislike and we have to mark their card on this year, but we feel that the direction of travel notwithstanding that blip is right, then we probably would not sell the shares. There might be other instances in which we would. We are trying to focus on building the long-term value chain.

Q187 Nadhim Zahawi: Just in terms of human nature being what it is, you have a human being, the corporate governance manager. He does not like a particular decision and wants to vote it down. It is very hard when he is integrated inside the fund management side. How does that work, at a personal level?

Anne Richards: It is not a separate individual. The team have collectively decided that this is a share that they want to have in the portfolio. Then there is a controversial issue around a particular event that is coming up. They will sit down and thrash it out around the table and then will decide, taking everything into consideration, what the right way to go on that issue is. They will decide it collectively as a team, so it is not two discrete, separate buckets. It is very much collectively round the table. That is how we operate all around the world.

Harlan Zimmerman: It might be interesting also to ask some of the panellists about their observations of other players in the market, because I believe there are very few institutions in the UK where the corporate governance manager will be able to overrule a fund manager on something. There are exceptions, of course.

Q188 Nadhim Zahawi: That is what I was heading towards: you may be forced to do something that you do not want to do if you are a corporate governance person.

Dominic Rossi: If you accept that asset managers have a dual mission, which is my starting point, we have to recognise that there are moments when those two goals are diametrically opposed to one another. When we get to those situations in our organisations, that is when my office steps in.

Q189 Nadhim Zahawi: So there is a sort of umpire above the decision. Do you do the same thing, Roger?
Roger Gray: I have never seen one of these animals, which is half in favour and half agin, but if one

walked into our office, yes, I would presumably have to resolve it. I think a lot is down to the culture of the institution. Our fund managers and our governance people do not speak a different language, hence we have not had that problem in practice.

Chair: Could we call it an asset managers code adjudicator?

Anne Richards: If it is a really controversial one, it will come up to me before we put it in the vote, just for a common-sense check. That is unquestionably the case.

The other situation that Dominic described was owning both sides of the shares in a transaction, where there is a clear conflict or the possibility of a conflict on that. We have a dedicated conflicts of interest committee who will meet and thrash around all sides to make sure that there is an objective view brought to bear on the situation. That is part of the broader managing of conflicts of interest that can arise unwittingly from time to time.

Q190 Rebecca Harris: How often do you exercise your voting rights? How often do you vote on company matters? What proportion of your rights do you use?

Anne Richards: We aim to vote all our holdings.

Dominic Rossi: The same.

Harlan Zimmerman: Always.

Q191 Rebecca Harris: My next question is void, in that case. When would you decide to consult your shareholders before exercising your vote?

Harlan Zimmerman: Clients, perhaps.

Dominic Rossi: Typically, we do not, because we have a very clear set of policies around what we are voting for and what we would vote against, and that policy is available to clients. To be honest with you, if you are voting thousands of times a year, it is not practical to approach shareholders on every single vote. But you will have institutional clients, particularly in the defined-benefit area, where the client will retain the voting rights and it is up to them.

Anne Richards: I would say that it is broadly the same. When we are awarded a mandate, part of that investment management agreement will typically cover the situations and the way in which we would expect to exercise the votes on behalf of the client, if it has been delegated to us, or will exclude it if it has not. We have a defined set of principles that clients receive ahead of time on which we will typically do our voting. So we would not normally consult clients before voting on their behalf, because it is a delegated function.

Harlan Zimmerman: For us, although we vote, it is very unimportant to what we do, because you do not use votes to make a company better. Voting is essentially, as it is being used in the UK, either a mechanism to stop bad things from happening—when the defence mechanism works and the governance people at USS and Fidelity, who are also good, by the way, get together and circle the wagons, so to speak, and vote something down—or the threat of that. That is a bad compensation plan, a bad takeover, something of that nature. But that is not activity that is really making the companies better. That is a form of

engagement that is very measurable, but it is not necessarily very meaningful if the objective is to steward the companies and improve them, as opposed to stopping them from doing bad things.

Q192 Rebecca Harris: Lord Myners talked to us about the concept of tracking error and how it might distort the behaviour of fund managers. I wonder if you can explain how this works and also what one would change in the practice to have a positive effect on behaviour.

Dominic Rossi: Tracking error is a statistically based measure of the likely deviation of returns of the portfolio versus the specified benchmark. It has some success, in my judgment, over time, in predicting what that potential deviation of return might be. But I do not think there is anybody in our industry, who has managed money for a long period of time—certainly no senior PM or CIO—who would rely exclusively on a tracking error measure of risk to predict in any way what his potential deviations of returns may be. The industry is full of such measures and tracking error is but one. The only thing I would say about tracking error and why it has a greater relevance than maybe others, which is possibly why Lord Myners referred to it, is that when clients approach us about specific mandates, they invariably are advised by their consultants to feel obliged to set a tracking error target for that mandate. Is it particularly reliable? It has some success, but I would not say it has much more than that.

Anne Richards: As a measure of risk it tends to focus on short-term volatility of prices as opposed to the real long-term risk, which is that you get back less than you paid for an investment. It is the risk of capital loss that is the long-run risk you should focus on. A lot of short-term volatility in markets is driven by potentially extraneous short-term factors. For example, the Italian election result causes a fluctuation in the prices of UK equity stocks, the majority of which are not going to be affected one way or another by what has just happened in Italy, but it is affecting the prices in the short term. It affects their volatility, which then is captured in this tracking error number, because it looks at volatility. That sounds a bit technical, but one of the problems with tracking error is that it does focus on short-term volatility as opposed to thinking about the longer-term risks that you really run with an investment.

The other criticism that one might make of tracking error as a measure is that it presupposes that the starting point to determine the riskiness of your portfolio is the index, because it is a measure against an index. Our starting point when we build a portfolio is to think about the economic drivers of the businesses that we are investing in—what is going to drive Unilever's profits over the long term? What is going to drive Persimmon's profits over the long term?—and think about those cash flows. The fact that they may be 0.5%, 1%, 5% or whatever the number might be in an index is, to a degree, irrelevant in the starting point for building a portfolio. So there are different styles of how you manage money in the market and tracking error does presuppose that you

are benchmark-driven in how you build your portfolio.

Harlan Zimmerman: I will try to put a couple of things together. Roughly, a tracking error is the extent to which you can deviate from a benchmark, say a FTSE 100. We are not index-oriented, but for a client of Fidelity, who comes and says, "Our consultant has said you should have a tracking error of no more than this", that would basically imply that they really must be invested in 90 out of 100 FTSE 100 companies. I do not know what the number is. What would the number be?

Dominic Rossi: It could be very different, but the point is still valid.

Harlan Zimmerman: The point is valid in that it means that they are forced to hold a widely diversified portfolio. If you look at, say, the largest company in the FTSE 100, which is HSBC at about 8%, or you take the top 10, because of this tracking error institutional investors will be forced to hold virtually all of them. HSBC they may think is a horrible bank and a bad investment for all the reasons that Anne was mentioning, but to have a zero weight in something that is 8% of your benchmark is virtually impossible. So you have to hold it at 2% or 3% or 4%, even though, by definition, you are saying you think it is a bad investment.

This is a root of many evils. It forces the portfolios to be much, much greater than they need to be. Simon Wong was talking about this in the earlier panel. It means that five very good, hardworking governance people at USS have to cover hundreds of companies, and it is just not possible. Many problems of the investment industry are encapsulated by the very phrase "tracking error"—it is the word "error." If you are not in line with the benchmark, that is an "error". That is a root of many problems, as I say, because it causes over-diversification of portfolios and an inability to pay for resources necessary to work with them in a good way. It comes from going up to the top, which Roger could tell us about, sitting on the top of a pension fund. This is how the assets are allocated from the top: a certain percentage in UK equities where you have an expected return of X advised by the consultants and, as a proxy for that, you use the FTSE 100 or the FTSE All-Share. Then, to measure how closely you comply with that, you use tracking error. Those bands are then set and instructions are given to Dominic and Anne and they do the best they can within those constraints.

Roger Gray: We are all fund managers, and talking about risk measures is something we could do for the rest of the day. The Kay report talked against tracking error and in favour of an absolute risk measure. The piece that probably all of us would agree on is that no single measure serves all purposes. I will not give a big defence of tracking error, but it has its place in the pantheon of things that you use to understand your portfolio. There are different ways to do this, but it also has its place in how you choose to say, "This is what we want you to do; this is your mission" and that mission could be a wide-ranging, absolute risk-oriented, concentrated equity portfolio with a lot of activism, or it might not be. Typically, a passive investment is going to own the index and tracking

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error is going to be kept very tight. I am not saying that there is no purpose for a passive, but it will be within context.

This would be an area, by the way, in which it is dangerous for this Committee or indeed any Government or regulator to step in and say “You cannot use tracking error.” It is like saying, “You cannot use part of basic statistics in your job”, which would be a nonsense, but has it been overused? Yes. My last comment on this is that it is much more important how a manager goes about selecting what they invest in than specifically how you define the length of the rope that they are allowed. I agree that “error” is unfortunate. You could call this “active risk”; that is a more statistically neutral way of defining it. I see tracking error or active risk as something that says, “How much rope are you playing with?”, but I should also, in empowering a manager to do that, know how they are going to go about selecting their investments and be supportive that that is something that is in the long-term interest of the fund.

Q193 Chair: Can I just intervene at this point? We are behind time. We have something like another 13 questions to ask. Please do not feel obliged to answer every question, but if there is one that you feel you can contribute to, feel free to write in with a written response to it. That might just cut down on the amount of time we take.

Q194 Mr Walker: Aberdeen’s marketing and website makes quite a virtue of the fact that you visit companies before investing in them. Given the global nature of your business—and you explained you are very global indeed—what is the resource that needs to go into that? How much of a commitment is that?

Anne Richards: It is a big commitment. We have three regional centres—the UK, the US and Singapore; we then have local offices that feed into those hubs and we have fund managers on the ground in all those places, so it is a big commitment.

Q195 Mr Walker: Is it typical among all investors that they are trying to do physical visits?

Anne Richards: It is variable. Active managers will not, as a general rule. Some feel they can do it by fly in, fly out. Some feel they do not need to visit companies. There are many different models.

Mr Walker: Are there comments from the other members of the panel on that?

Roger Gray: We have all our investment team located in London. Co-location has plenty of advantages as well. Lines of communication are short. It does mean that they are spending a bit more time in airports than they might otherwise do.

Dominic Rossi: In my area, there are 600 people globally. Most of them are investment professionals, analysts and fund managers all over China, Japan, Asia, Europe. It is very much a local branch structure when visiting companies.

Q196 Mr Walker: That does mean that you will get out visiting companies on the ground rather than just head office.

Dominic Rossi: Absolutely. Indeed, we have always placed an emphasis, as a company, on proprietary fundamental research, so our analysts are building their own financial models of the companies. But it is not simply the companies in which we invest; it is across the whole market. It is pretty much waterfront coverage.

Harlan Zimmerman: We are different, because we have only 10 to 12 investments at a time. We have 22 investment professionals, two professionals per investment, so we would normally meet the companies dozens of times, literally, before we invest; that is very different. But I would say the vast majority of these sorts of visits that most institutional investors would conduct, even the best of them like Fidelity and Aberdeen, will be focused on understanding the company. This is not necessarily a feedback session where they are trying to improve the company. They are trying to use the information to make good investment decisions.

Q197 Mr Walker: A quick question to Roger: in terms of balancing fund management and corporate governance, do you feel that the pension industry has a different approach to the investment management market or is it very much the same?

Roger Gray: If you look at the industry as a whole, it is a highly intermediated arrangement, so most funds rely on external managers for the vast bulk of what they do. Therefore, it is rather important that they select those managers well and incorporate what they are expecting in terms of corporate governance behaviours within those mandates.

Q198 Mr Walker: Can I just ask two quick questions? One is about activist investors. A lot of the evidence we have heard in our earlier sessions, from Kay as well as from Lord Myners, has been very much that we want to see more activist investors. You described yourself, Harlan, as an activist investor. Could you differentiate what you feel makes an activist investor?

Harlan Zimmerman: Yes. The primary distinction is investing with a plan to do something. Governance, as I mentioned before, is often at the root of that. It is investing in a company that you might think is good but could be doing better. It is a full integration of the governance and the investment, as opposed to making an investment in a company that you think is good and then, if something is not going according to plan, mobilising your limited resources to stop that from happening. That is the single biggest distinction.

Q199 Mr Walker: I also see what you do is based very much on a concentrated portfolio.

Harlan Zimmerman: Yes. You cannot do it when you have 100 companies in the portfolio. Arguably you should, but it is just not practical.

Q200 Mr Walker: Looking at the brief CVs that we have, I think you are the only person on the panel who has spent time in the hedge fund side of the investment industry. I do not know if anyone else on the panel has done. Some of the evidence that we have heard has been very critical of the role of hedge funds,

in particular in driving a transaction-based focus and using their power as activists to drive through deals to make short-term gains against the interests of long-term value. Do you recognise that criticism?

Harlan Zimmerman: Yes, I do, absolutely. I do not think it applies to us, it will not surprise you to hear, because we do not use leverage. We do not short; we do not hedge. All we do is buy the equities and, as I say, we have an average holding period of about four or five years. But definitely, when markets are buoyant there are certain types of hedge funds that can easily get capital, the main provider of which, by the way, is pension funds. They can easily get leverage. They are short-term focused, and they then hunt in packs and seek to put companies in play or extract jumbo dividends or things of that nature. It was a strategy that was thoroughly discredited after the financial downturn, but I fear there will be more of it over the coming years.

Q201 Caroline Dinéage: On the basis that your voice is okay, can I just ask you this? Professor Kay recommended that companies should consult their major long-term investors over major board appointments. I just wondered what voice they have in terms of appointments and how that is connected to the role of non-executive directors.

Harlan Zimmerman: I will definitely make it through this question if you can. I have pointed to the importance of non-executive directors, and I think Kay does an excellent job of focusing on the agency problems in different parts of the investment world, but this one has been overlooked, I believe. It is the single biggest problem, arguably, in that, as I mentioned before, the investors are given the vote on who should be not just the non-executives but all the directors, but particularly the non-executive directors, so that they can act as stewards for our companies. Fidelity, even with the best will in the world, cannot look after the day-to-day operations of thousands of companies, so we have nonexecutive directors who are there, who are supposed to be doing that job for us.

Now, the companies will say they do consult with their major shareholders on nonexecs, and the asset managers will say that they do consult as well, but the reality is that when that happens it is a very superficial consultation in most cases. It very often takes the form of a Sunday night call before an announcement on Monday. If you look at one single damning fact, director elections here in the UK for nonexecutives are a rubber-stamping exercise. Between the 2009 financial crisis and the 2012 shareholder spring, in the FTSE 100 there were 3,042 director proposals that came to a vote. 3,040 of them were elected. The average yes vote was 97.5%. The statistics are no different in the 2012 shareholder spring from what they were over that time period.

Now, some people will say “Yes, but there was behind-the-scenes activity” and, yes, that is true. There were also 10 directors who were proposed and then, for various reasons, stood down before the election. These are not our figures; these are figures from PIRC. The numbers are just as bad when you go to the FTSE 250. So what do you have here? You

have, to borrow from Lord Myners, a North Korean voting system where the effect in reality is that the chairmen of the companies, who head the nomination committees, are effectively choosing their own boards. They are choosing the people who will act as our stewards, who will sit in the boardrooms, who we are asking to challenge the management team for us, to challenge the chair when a decision is not good. We are creating a dynamic that is totally wrong.

Of course there are excellent NEDs, and there may be some chairmen who say, “I want a bunch of really tough people in my boardroom, who are really going to challenge me”. But human nature probably leads to them picking people who do not necessarily have that attitude. Secondly, the people going into the room know that they are beholden to the people who put them there, the very people who are asking to be challenged by them. So a very big question is why we are not doing a better job of involving ourselves in not just the rubber-stamping but the actual nomination of non-executive directors, which is being done very successfully in some other markets such as Sweden and Norway, where they managed to avoid many of the problems that we had with lack of challenge, for instance, during the financial crisis.

Dominic Rossi: Could I add a little colour on that? Some of those comments I completely agree with, but our experience is somewhat different at the same time. First of all, the call on the Sunday night about a major acquisition, etc, is absolutely true and there are good regulatory reasons for that. Also, the voting patterns are a matter of fact. However, our own experience is that we, particularly in the United Kingdom, are quite actively involved in the nomination of non-executives, whether it be the chairman, the SID or the non-executives. In many cases, not only are we asked our views on individuals and whether they are suitable to sit on a board before the nomination is made, but quite frequently we are asked whether or not there is anybody that we might wish to suggest. We are asked to put forward a name. So I do not think that the dialogue that currently exists between boards and major shareholders like our own is so sterile that we have no influence over nominations, because there are clear instances where we have been very influential in who is on the board and who is the non-executive chairman.

Q202 Caroline Dinéage: With that in mind then—this is for all the panel—are there any instances in the last 12 months when voting decisions went against the recommendations of company directors or chairmen?

Dominic Rossi: I have just gone through the voting report. We have voted against with 20% of our votes, usually on management incentives.

Anne Richards: I do not have the number to hand, but we certainly are on record as having—

Chair: Could I suggest that this might be a question that readily lends itself to a written response afterwards, so I think we can move on.

Q203 Caroline Dinéage: I just wonder if any of the panellists practise high-frequency trading in their institution.

Harlan Zimmerman: No.

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Dominic Rossi: No.

Roger Gray: Not in our institution. We have some hedge fund managers who engage in trading practices different from what we could possibly do and would possibly do and it tends to be not in individual shares, but in futures or currencies.

Q204 Caroline Dinenage: It has been reported recently that the German Government intends to introduce a clampdown on high-frequency trading because it creates excessive market turbulence. I just wondered whether you thought the UK should follow suit.

Anne Richards: We have talked a lot about agency problems in markets, in the generic long-term investment food chain and the implications of that. There is another subset of market behaviours that have become technologically possible in a way that they were not before and I do not necessarily think that the market processes around the control of that or the taxation rules have kept up with the changes that technology has allowed. It is certainly an area that would benefit from much closer examination into what the genuine impact is. That is not a small thing in terms of studying and enabling it to be done, but it should be done, because there are some unintended consequences of permitting it. There are potential benefits from increased liquidity, so it is not a one-way street, but in terms of looking at the balance of the pros and cons, it would merit much closer observation than has hitherto been the case.

Harlan Zimmerman: I do not see that it brings any benefit to society whatsoever, personally.

Q205 Caroline Dinenage: The next question has largely been answered, in that case. Do you make use of derivatives or short-selling in your institutions?

Harlan Zimmerman: We do not short-sell, and we normally do not make use of any derivatives other than for short periods of time when we can buy exposure to a company indirectly.

Dominic Rossi: Our philosophy is that we like to find companies, buy them and own them. Shorting as a concept does not fit particularly easily with that overriding view of why we exist, but in some strategies for protection we do use principally index-based futures. Our involvement in single-stock shorting is extremely limited.

Anne Richards: The vast majority of our business is what you would call plain vanilla, long-only investment. As Dominic has mentioned, we use derivatives to provide market protection in certain instances or to effect a market view through futures or forwards on occasions. And there are occasions on which rather than buying an equity share by buying the physical stock, we will choose to get access through buying or, indeed, in some cases, writing an option on a stock. It is a very small part of our business and we just use it as another tool to get the economic exposure that we want.

Roger Gray: We do not engage directly in short-selling individual shares, but we do use derivatives for either hedging purposes or efficient portfolio management, which is the most effective way

promptly to execute a particular exposure that we wish to achieve.

Q206 Caroline Dinenage: Professor Kay recommended that income from stock lending should be disclosed and rebated to investors. Could those who feel they would like to contribute explain their interpretation of that recommendation and how it would affect the market and address the public distrust of short-selling and stock lending, please?

Dominic Rossi: On the stock lending, first of all, it should be very, very clear that the income derived from stock lending belongs to the client. That should be absolutely clear. The only subtraction from that would be administrative fees related to the stock lending programme, but the income belongs to the client.

With respect to the practice of stock lending, again, my board is extraordinarily conservative about this. The idea that we would lend the stock that we obviously like, otherwise we would not own it, to someone who is then going to short it does not really make much sense. It is not in the interests of our clients to have to foster that short-selling, nor is it in the interests of the company in which we invest. We do a very limited amount related to dividends and I suspect even that practice will stop shortly.

Anne Richards: We do not do stock lending in the majority of our portfolios. We have a number of funds where the board of directors have taken the view that stock lending is a valuable additional income and they wish to exercise it. Aberdeen did a review of this area last year and from the start of this year we took the view that in the interest of full transparency we did not even want to keep an administrative fee for Aberdeen. So we now take no direct income from stock lending whatsoever for any of our portfolios, but again it is a relatively small number of our portfolios that were in any case using stock lending.

Roger Gray: We do engage in stock lending. There is an administrative fee taken by the custodian who provides the service. We recall our stock for voting, which rather materially reduces the amount of lending we undertake.

Harlan Zimmerman: We do not do it at all.

Q207 Caroline Dinenage: Finally, Professor Kay told us that he thought a financial transactions tax could be a positive way of discouraging short-termism. How could such a tax be implemented so that it had a positive rather than a negative impact?

Roger Gray: We have one already in the UK—stamp duty—and it is quite high, so I am not sure that it is germane to this particular discussion of the UK equity market.

Anne Richards: I would just add to that. It is true we do, but it is not equally applied to all instruments, therefore there are ways of getting economic exposure that could get around it. So again, on the point that I have made a couple of times, looking at the tax regime and making it more economically consistent across a range of instruments would perhaps get around some of these behaviours. But it is quite a difficult area to see how you would implement a financial transactions tax in a really beneficial way to the end customer.

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Dominic Rossi: The point is, if the purpose of a financial transactions tax is to prohibit superhectic trading on the London Stock Exchange, it is not going to work. If it is to raise revenue, I think it will work spectacularly well.

Harlan Zimmerman: I personally support looking more seriously at fiscal and other measures that compel people to be more longterm. That makes it more costly for them to be short-term, and I believe that is why it is in the report.

Q208 Chair: There is just one thing that arose from the response to that question. Roger, you said we have an FTT and it is stamp duty. Yet everybody else says a financial transaction tax cannot work. If we have one, and presumably it is working, why can't any other form of financial transaction tax work? Is there anybody who could respond to that?

Dominic Rossi: I was agreeing with Roger. The fact is, here we are with a Kay report troubled about shorttermism in the stock market, despite the fact that we have a transaction tax called stamp duty. If stamp duty or a financial transaction tax was a cure for

shorttermism, we would not need the Kay report, because we would have solved it through stamp duty.

Anne Richards: I know time is limited, but I would just add to that. It seems to me that if you want to stop high frequency trading, if you choose that as your route, the most obvious route to take is to prevent people buying and selling within a certain time period. A tax is an indirect way of trying to influence the behaviour. If it is the behaviour you want to stop, stop the behaviour.

Chair: So you are talking about the German approach.

Can I thank you? It has been a marathon. I do appreciate your contribution. As I said, there are some areas that perhaps we would have wanted to explore further but have not. If you could respond in writing to the one question that we did not take, I would be grateful. Similarly, if you want to submit any further evidence to us, feel free to do so. If necessary, we will write to you with any questions that we feel retrospectively we should have asked but have not, and we will be grateful for your reply. Thank you very much.

Tuesday 5 March 2013

Members present:

Mr Adrian Bailey (Chair)

Mr Brian Binley
Paul Blomfield
Katy Clark
Caroline Dinenage

Julie Elliott
Rebecca Harris
Nadhim Zahawi

Examination of Witnesses

Witnesses: **Anita Skipper**, Corporate Governance Adviser, Aviva Investors, **Steve Waygood**, Chief Responsible Investment Officer, Aviva Investors, **Neil Woodford**, Head of UK Equities, Invesco Perpetual, and **Chris Hitchen**, Member of Kay Advisory Board Team and Chief Executive, Railpen, gave evidence.

Q209 Chair: Good morning. Thank you for agreeing to help the Committee with its inquiry into the Kay Review. I will start by asking you to introduce yourselves for voice transcription purposes. Can we start with you, Anita?

Anita Skipper: I am Anita Skipper, and I am the Corporate Governance Adviser at Aviva Investors.

Steve Waygood: Good morning. I am Steve Waygood, the Chief Responsible Investment Officer at Aviva Investors.

Chris Hitchen: I am Chris Hitchen, and I am Chief Executive of the Railways Pension Trustee Company. I served on the Advisory Board for the Kay Review.

Neil Woodford: I am Neil Woodford. I am a fund manager at Invesco Perpetual. I have worked for the same company for 25 years, running the same funds for most of that period.

Q210 Chair: Before we start the actual questions, I should say that we have a lot of questions and not much time to get through them. Some questions will be for the whole panel, but do not feel obliged to contribute if you feel that the previous speaker has covered any points that you wished to make. Obviously, if you have something to add to or subtract from what has previously been said, feel free to do so. Brevity is much appreciated.

I will start by going back to Lord Myners, and this is a question for the whole panel. When he did his report 10 years ago, he called the intermediary regime too complex, but so little has happened since then that Professor Kay stated that the “chain of intermediation should be shortened”. Why do you think the industry ignored Myners’s initial call for simplicity? What lessons do you think we should take from it? Who would wish to lead on that?

Anita Skipper: One of the reasons is that pension funds had a lot of other issues to deal with over that time—their own deficits and the governance of their own teams—and so the stewardship stuff came down the agenda. I think it stayed there because the economy and the issues for pension funds have been so great. Also, part of the reason is that pension fund trustees are not always experts on these issues, and the intermediary chain has increased because they need to get advice, they need to be confident that what they are doing is right and, if they are not, they need to employ people who can advise them.

Q211 Chair: You are saying that basically it just was not high enough on their list of priorities, and I think the issue of the lack of understanding of pension fund trustees is well understood. Is there any other member who would wish to add to or subtract from that? Chris Hitchen?

Chris Hitchen: I would substantially agree with what Anita said, but I would say that large pension funds have done a lot over the last 10 years to take control of their intermediary relationships, bearing in mind that they were only part of the whole picture. Certainly Kay in his report was very aware of the fact that it was not just about large pension funds or even pension funds in general; it was about all investing, and clearly there are many investors who are not represented at all. He was trying to find mechanisms that worked for the market as a whole.

Q212 Chair: That is an important point, because whilst it may be possible to argue that the pension fund managers had a specific set of problems that they may have prioritised, that is not really true of the industry as a whole, because they did not have quite the same set of problems. Did they just not take it seriously enough?

Chris Hitchen: Speaking for my own fund and for the pension fund industry generally, we took the Myners report extremely seriously. As I said, in many ways trustees have upped their game over the last 10 years. Anita is absolutely right: this has not been an easy decade for institutional investors generally, but for DB pension funds in particular we have had to contend with rising deficits, closing schemes, employers that can no longer afford to pay—all those kinds of things. These are big issues, and there have been secular shifts in the way institutional investing is organised in the UK. We are in a bit of an interregnum. I happen to run an open DB fund but there are not many of us left. There is going to be a new world of defined contribution schemes, which auto-enrolment is going to empower.

Chair: I agree with at least half of that statement; it has not been an easy decade for investors, but an awful lot of people have done very well out of it. I will perhaps try to focus.

Chris Hitchen: I would agree with that, too.

Q213 Chair: You have partly anticipated my next question, which was: has there been any strengthening

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or hardening of the regulation of the institutional investors? You have said the pension fund trustees have upped their game. What progress has been made, if any? I am quite happy to take a contribution from anybody, but, Chris, do you wish to elaborate on what you said previously?

Chris Hitchen: In the context of the interaction with UK companies, I would say that more investors are fully engaged than was the case 10 years ago and the extent of that engagement is much deeper. We have seen developments in stewardship codes, and we have seen more and more commercial asset managers getting involved, partly due to their clients asking them to do so.

Anita Skipper: I would not quite agree with that because, bar a few exceptions like Railpen, USS and a few of the large commercial ones, our experience is that many pension funds do not prioritise this at all. In fact, some today do not even know what the Stewardship Code is. There have been improvements with some of the larger funds, but a majority of them still do not even know what this whole issue is about.

Q214 Chair: It is a point made by FairPensions, PIRC and others: whilst some are aware and have signed up to the Stewardship Code, plenty have not, and for some of those that have, it is a pretty tick-box exercise. Steve, you wanted to come in?

Steve Waygood: Yes. Thank you, Chair. Your question was about the progress we have seen in the industry over the last, say, decade or so. If I think about the system, and I know that Professor Kay was looking for a systemic response to the problem of short-termism, there has been a lot more work in the area of stewardship or corporate governance by some of the sell-side brokers. There has been more work by consultants, and I would particularly point to Mercer and Towers Watson as doing reasonably good work in the area of analysing corporate governance and stewardship by buy-side fund managers.

Can I share some data that we have done at Aviva Investors? We have analysed three years' worth of the signals that we get from the market: the requests for proposals; the requests for information; and due diligence questionnaires. Some 89% of those requests for information ask questions relating to, "How do we behave as good stewards?" If I think back over the last 10 years, that is a significant transformation in the demand that at least some schemes are putting into their tendering process.

However, we cannot see how heavily that is weighed, and after take-on, with some notable exceptions, the vast majority of schemes do not raise questions regarding stewardship after we have become their fund manager. In other words, what I believe is that, whilst there is a significant number of questions now in these requests for information, it is almost a housekeeping exercise. It is not treated substantively importantly.

Q215 Chair: That is important. You said initially the requests that came from the market; are you talking about basically pension fund trustees? Who else might that include?

Steve Waygood: Our institutional clients, so, yes, you could consider them to be that, or foundations—institutional investors that come to us looking for a segregated mandate. We have analysed over 1,000 types of those different questionnaires that have come to us, so it is a meaningful piece of work. The average number of questions per questionnaire is six and a half, so broadly 10% of each questionnaire covers this area.

However, as I say, we cannot see how heavily it is weighted in the final decision, and our experience is that it is not heavily weighted in the final decision. But that is experience; it is not knowledge. Also, after we have been secured as the fund manager, there are literally only a handful of schemes that hold us to account for delivery of stewardship in a substantive way. In other words, demand is missing and, as an observation on the Kay Review, what he focuses on is supply—supply of more stewardship. I do not think there is very much in there that will lead to increased demand for stewardship and an informed oversight environment.

Q216 Chair: Could you very briefly outline how that demand could be increased?

Steve Waygood: With pleasure. The entire system has a role to play. Trustees should be very transparent with pension beneficiaries about what stewardship has taken place, and there could be a requirement for that to happen. Pension schemes should also be required to embrace the Stewardship Code, and comply or explain. Investment consultants have, I believe, an obligation, a duty of care, to scrutinise fund manager performance in this area and proactively raise it into the discussion with their clients.

At the moment, my understanding, based on some evidence, is that investment consultants—who are centrally important in the UK fund manager selection environment; I cannot overemphasise their importance—very seldom proactively raise this area in their advisory environment. They could and should be required to do that. Fund managers, for our part, should be more transparent with their voting record collectively as an industry, and there are other reports that we could be producing. I could carry on, but you asked me to be brief.

Q217 Chair: I think we got the gist. The next obvious question is: how could you enforce or change that environment without intrusive regulation? Do you think the investors' forum that is being proposed would have a role?

Chris Hitchen: I think it could. It is certainly something that we debated extensively in the Advisory Board. It is not as if it has not been tried before. I have even been involved in some previous attempts to provide an umbrella where investors can come together.

I think what Kay had in mind was something very specific: where there is an issue of the day with a particular company, there should be a safe place where all investors with a legitimate interest can gather together to discuss that and not worry about whether they are going to be seen as part of a concert party, or

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whatever it might be, because there is some implicit, if not explicit, Government backing for the endeavour. We recognised that it was very important that we did not just capture large pension funds or the big asset managers who operated for them. It was important to have everyone in the tent. Bear in mind that, of the £18 billion fund that I run, I should think less than 10% of it is invested in UK equities today. There are many international investors operating in a very significant way in the UK market. They all need to be brought into the same tent, and it was really an attempt to try to create that.

Q218 Chair: Can I move on? One of the things that emerged from our previous panels and questioning so far has been the nature of fund management and its disconnect from the companies whose shares they manage, largely because they have so many. When we questioned Myners, he questioned this idea that fund managers should talk about company strategy or be more closely involved with the individual company strategy. His line was: “Most fund managers have not done anything other than work in the City. They have never run a business,” and I presume that he is assuming that they do not really understand business anyway. What is your view on that? Anita, you are smiling. Do you want to lead on that then?

Anita Skipper: I was just looking at the fund manager. In our little group of fund managers, we actually do have fund managers who have run businesses themselves. The role of the institutional investor is to challenge the strategy that companies have put forward. Then we can decide for ourselves whether or not we believe it, and whether or not we will put money towards it.

Q219 Chair: Isn't that more easily done if the fund manager has been in a business and basically knows what it is all about?

Neil Woodford: Not at all. No, I do not believe so. I do not believe our role as fund managers is to tell companies how to run their businesses. We are there to hold their feet to the fire on things like capital allocation and strategy. In some respects, having run a business might be a disadvantage. That may sound a little odd, but the fact is that the interaction between a company and its shareholders should be based around holding management to account with respect to the shareholder agenda, and making sure that the board behaves appropriately with respect to its shareholders and particularly with respect to capital allocation. Essentially, fund managers are capital allocators; that is what our expertise should be focused on. That is where I think there is a deficit of understanding on boards. Capital allocation tends to be the issue on which we engage most actively with companies.

We are not experts in how to extract more working capital or where to cut costs or where to invest in terms of the micro-management of the business, and I think that would be counter-productive. Boards would become dysfunctional if all their fund managers were trying to chip in and tell them how to run their business. We are not trying to do that; we are taking a step back from that and operating at a higher level.

Chair: Brian Binley wanted to come in with a supplementary; he, of course, has run a business.

Q220 Mr Binley: And I have founded two. I might be very annoyed if fund managers tried to tell me how to run my business when some of the records suggest they cannot run their own business. That would concern me. Isn't there a very fine line between the sort of scenario you paint, and going slightly further and being involved in the prime decision-making of a given company with regard to the important issues that you are not equipped to be involved in? Isn't there a fine line and isn't there a tendency on occasions to go over that line?

Neil Woodford: It depends whether you behave like an owner or a trader, frankly. As a fund manager, my average holding period has recently been as high as 16 years. At the moment it is a bit below that but it is certainly above 12 to 13. You can imagine that, when you have that sort of relationship with a business and you are typically holding a business for that period of time, you probably see three chief executives come and go during that average holding period and you see the board turn over many times. So you are the longevity in that sort of relationship, not the board or the executive.

You can imagine in that sort of relationship, where you are a long-term shareholder, you are engaging with a company principally on strategy and capital allocation. In those sorts of situations, we think it is our responsibility to engage with that company, and to give our advice and ha'penny worth on how they should allocate capital.

Q221 Mr Binley: You did not quite answer my question, so I will press you a little further. The truth of the matter is doesn't Kay—and, by implication, Lord Myners—think that big pension fund holders are too involved in the direction of business? Isn't that the question he is really asking?

Neil Woodford: No, I do not think so. I do not read it like that.

Q222 Mr Binley: Having talked to him, I do think so. Let us accept that as a starting base. If that is the case, isn't that a dangerous situation, where the imbalance between the big fund holders and other shareholders is out of balance?

Neil Woodford: I can envisage a situation where, if fund managers or asset managers were disproportionately empowered to intervene or felt that their responsibility was to intervene in the day-to-day management of the business, that would create an imbalance in the relationship between the owner and manager, and would create confusion. The problem that I see today is the complete opposite, in that most fund management groups really do not behave like owners; they do not think like owners. If something goes wrong at a business, or if something happens in that business that they have not anticipated or the share price underperforms for a quarter, as Kay emphasises, they emphasise sale over voice. You have got to have a long-term perspective to emphasise voice over sale.

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My view is that the problem is the complete reverse: there is not enough engagement. Institutional shareholders do not take enough of an interest in the strategic direction of a business. There might be quite a lot of engagement over executive remuneration or non-executive director RemCos, etc., but to my mind the lack of involvement principally focuses on that sort of engagement around strategy and capital allocation.

Q223 Chair: I just want to come to a couple of quick questions. We have been on this theme for some time. This is to you, Neil, because in your *Policy on Corporate Governance and Stewardship*, you state that you will only “vote on shares listed outside of the UK, Europe and the US by exception”. Why is that?

Neil Woodford: I do not know, to be honest. I am a UK fund manager, although I hold shares in companies quoted in other markets in my funds. I run about £32 billion and about 20% of that is invested in businesses quoted on other markets. We do vote those shares. I am not responsible for the other fund managers in the other parts of the organisation. I read my Stewardship Code the other day and thought it was a worthy document, but the problem is not really in the documentation or in the policy; it is actually in the implementation.

Chris Hitchen: At the Railways Pension Fund, we do vote our shares around the world, and we have a small team that works really hard to make that happen. We also partner with other institutional investors around the world. It is not a costless exercise by any means. It is really quite difficult to do it properly, and especially if you are going to engage with the companies as well, there does need to be enough resource put behind it.

Anita Skipper: Yes, that is important.

Q224 Chair: To a layperson it would seem that, if a fund had a strategy for investment, it would exercise that strategy consistently with both UK and other companies. It seems a little odd. My next question was going to be: is this typical of other companies? From what you said, Chris, it is not necessarily typical.

Chris Hitchen: It is typical of our fund and a number of other funds.

Q225 Chair: What is the view of the industry in general?

Steve Waygood: I can certainly agree with everything Chris has said—and, for that matter, Neil. We vote our shares on the MSCI World Index very actively. One reason why other fund managers do it less might be because of asset allocation decisions in our UK market. We tend to run a lot of UK equities, and as a consequence of that you will own more of a company in the UK than you would of a company in, say, Japan—or France for that matter. Therefore, if you own less of it, your return on your stewardship engagement will be lower and your ability to influence the company will be lower.

You should regard our industry also as one that is resource limited. We need to focus our resources on those areas where it is going to provide the greatest

return to our clients, and that often means companies where we have got the biggest investments in market cap terms.

Q226 Chair: Again you have partially anticipated my next question: how much of a burden would it be? I will bring you in in a second, Neil. In effect, the more companies that you invest in, the greater the potential burden if you wish to scrutinise them closely. Of course the more foreign companies, I would guess, the greater the running costs. From the nodding of your heads, is that a reasonable observation?

Chris Hitchen: Yes.

Neil Woodford: There can be a disproportionate focus on voting as representative of your corporate engagement. In the environment that I experience day to day in the UK, corporate engagement is a bit like an iceberg. The bit that you can see above the surface is your voting record, but the vast bulk of your engagement is actually below the surface. It is not obvious how you engage or when you are engaging. Typically, when we get to the point where we are abstaining or voting against various corporate executives, that tends to be the surfacing of legacy issues that we might have been debating with a company for maybe years. It would be wrong to correlate a voting record necessarily with your level of corporate engagement. Lots of people vote but do not say or do any corporate engagement.

Q227 Chair: I would certainly accept that observation, but to turn it round the other way, it seems odd, if you were engaging, that you did not actually exercise your vote.

Neil Woodford: Indeed. I agree with that, yes.

Q228 Chair: So, on the surface, there is an awful lot of non-engagement in companies that substantial funds are invested in?

Chris Hitchen: Chairman, I think Professor Kay would agree with your premise that many fund managers are over-diversified, effectively, and it limits their effectiveness in engaging. I would say that Neil is an honourable exception in that. Kay’s proposal to deal with that was that fund managers should have much more conviction, hold smaller portfolios and be much more prepared to deviate from market benchmarks. That of course requires us as customers to set them benchmarks that are more appropriate for a long-term approach. I think he envisaged a market place that was bifurcated between very active investors and effectively an indexed—tail to mop up the rest of the institutional assets. It is very important that we have proper stewardship of those passive assets as well.

One technical issue is that, to the extent that even large funds like ours invest through pooled vehicles, whether passive or not, it is sometimes hard to get the fund managers of those pooled vehicles to give you your share of the ownership rights and to vote in the way that you would wish. One thing that Government could think about would be more than polite encouragement of fund managers to do that.

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Q229 Rebecca Harris: We spoke last week to four representatives of the fund management industry who all seemed to have quite commendably high levels of exercising their voting rights, but not one of them actually consulted their clients on how they wanted them to vote. How typical do you think that is of the industry generally?

Steve Waygood: When one tries to do that, clients often tell you—but by no means all of them—that they have got other priorities on their mind, and this area is extremely complicated. If, for example, we were to bring them our Stewardship Code or our corporate governance policy and explain in detail how we vote, that would take a good few hours of a trustee meeting, and it is generally, typically, not something they are willing to invest the time in. They will delegate it to us. They will expect us to report back to them on what we have done in our quarterly reporting. Again, I mentioned earlier the lack of interest post take-on, post us running the funds, and with the honourable exceptions excluded, I can count on one hand the number of questions over the last 15 years I have had on the content of the stewardship section in the investor report that we give our clients. It is a problem of time being allocated by clients to this area, but by no means all of them.

Neil Woodford: In my organisation, and certainly within my area of responsibility, I have hundreds of thousands of clients—individual savers through ISAs and investment products—and it is not possible to engage with them to evaluate what they would like me to do specifically on each individual issue. I make a point of expressing to their representatives, the IFAs and the interactions I have with their representatives, how important I think corporate engagement is, and I think my track record speaks for itself on that front.

Unfortunately, it is impossible for us, or me specifically, to get a clear view of exactly what they want me to do on each specific issue and in generality even. I think the overwhelming desire is for fund managers to take ownership responsibilities seriously. That must be a given, and I assume it to be a given, amongst my investor base, and I take that seriously.

Chris Hitchen: I think the challenge for Government might be how to construct stronger governance models to represent investors. We keep going back to pension funds and particularly large pension funds, where the trustee model arguably does provide some level of oversight and governance, and you are saying it is weaker further down the chain.

We have a lot of subscale pension funds in the UK, but we also have hundreds of thousands of other unrepresented retail investors, as you say. I am involved with an initiative called Pensions Quality Mark, which is trying to build good governance into the new defined contribution schemes that are coming up, but arguably we need something even broader that would cover Neil's clients as well.

Anita Skipper: Something that one of our fund managers suggested was that, if you have retail clients, you should have a “meet the fund manager” once a year. So if you are running unit trusts where you have lots and lots of investors, you could have a day like an AGM that companies have but you would actually have the fund manager there, who will answer

questions from any interested individual who might want to turn up and find out how you are running the fund for them.

Chair: That is a very interesting suggestion.

Q230 Nadhim Zahawi: Just picking up on Neil Woodford's point, explain to me why it is impossible for you to engage with them.

Neil Woodford: Kay talks about disintermediation and the complex chain that exists between saver and company. The fact is that our relationship with our clients is dis-intermediated by umpteen different representatives. It is just not possible for us to access them.

Q231 Nadhim Zahawi: Why is that? There are technologies available now that mean you can talk to all the different stakeholders.

Neil Woodford: We often do not know who our clients are.

Q232 Nadhim Zahawi: Shouldn't you find out?

Neil Woodford: We cannot find out; we are not allowed to find out. We do not own the customer relationship, for example. It is owned by intermediaries.

Q233 Nadhim Zahawi: So you could consult with the intermediary.

Neil Woodford: Yes, we can, but again, coming back to the point that has been made here, many of those intermediaries are not interested in asking you about corporate engagement.

Q234 Nadhim Zahawi: It depends how you ask them, right? There are technologies available now for you to engage. This place engages with hundreds of thousands or millions of people. Other countries do the same thing in lots of different areas of business. It is available. I put it to you that there is a sort of reticence from your side of the fence to say, “Actually, that is the way we have always done it; we are going to carry on doing it that way because my reputation speaks for itself,” which is fantastic, but you should not close your mind to what is available nowadays. There is technology that has moved on.

Neil Woodford: I am very aware of what technology exists.

Nadhim Zahawi: So why not use it?

Neil Woodford: I am not suggesting that my industry is doing a good job. By the way, I am not defending it.

Nadhim Zahawi: It sounds like it.

Neil Woodford: I am saying that I am an exception in the industry. I take corporate engagement very seriously and I spend a lot of time on it. I can submit umpteen amounts of evidence to demonstrate that.

What I am saying to you is that typically I am on my own when I am engaging or among a very small number of people who are engaging with companies. The industry, I believe, is failing on this point. I am trying to offer some explanation as to why. But it is possible, even when you do not have that direct relationship with your clients, to accept the responsibility of ownership, as I do.

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Q235 Nadhim Zahawi: The issue I am taking up with you is you opened with a statement saying, “It is not possible for me to engage.” I do not believe that is true in today’s world. Thank you, Chairman.

Chair: I think Steve Waygood wanted to come in on this.

Steve Waygood: Thank you, Chairman. Many companies routinely now engage with stakeholders, and that kind of engagement is, of course, something that we support and encourage them to do. We, as Aviva, have 14 million retail customers in the UK. Whenever we have raised questions like this, many of them, once it is explained to them what it is we are doing, are genuinely interested in understanding more. However, I mentioned at the very beginning of this meeting that the active informed demand for good stewardship is missing. To me, this is a function of poor financial literacy in the UK. There is an opportunity in the revision that is currently under way of the syllabus to integrate issues of stewardship within that. Of course, that is a long-term way of dealing with a short-term problem. It will take many years before those people are demanding good practice from us.

The central problem is demand—informed demand. They would also need quick and efficient ways of overseeing something that is very complicated, so any work that is being done to develop a standard is something that we would very strongly welcome.

Q236 Rebecca Harris: What opportunity is there now for clients to make their views known to you? What opportunity is there for clients to influence your voting decisions at the moment? This is particularly to Neil.

Neil Woodford: In my particular example, when I interact with clients, or when people who work with me interact with our clients, there is an opportunity then for them to express their wish and their desire for us to engage with the companies in which we are investing. I absolutely agree with the point that has been made on this panel, which is that there is very little attention paid to this. Sometimes we are offering up the whole subject of corporate engagement and activism with our clients, rather than the reverse.

Chris Hitchen: It depends on who you mean by client, though, doesn’t it? If we are looking through to the end investor, then I accept it is not impossible but I would agree with Neil it is difficult. One of the Kay recommendations was that Government should facilitate individual electronic registration, which has really not happened in this country. That would make it much easier to democratise shareholders.

Where the client, as far as the fund manager is concerned, is a governing body such as a trustee, the mechanism is there for that relationship to happen—for the client to instruct the fund manager. We certainly do that. But I would say that fiduciary duty is a concept that occurs a few times in Kay’s report, and it really goes to the core of my job. It is not the same thing as doing what your members want you to do; it is doing what is in their best interests, and those two things are not always the same.

Nadhim Zahawi: But you can explain that.

Chris Hitchen: Indeed.

Q237 Rebecca Harris: This is a question for Anta Skipper and Steve Waygood. Aviva was recently forced into this “shareholder spring” spotlight last year, when about six out of 10 votes failed to support the pay policies the company put forward. Firstly, what proportion of Aviva shares are held by institutional investors?

Steve Waygood: I should emphasise we work for Aviva Investors rather than Aviva, so we will need to come back to you to give you an absolute fact. I would estimate the majority, if that gives you a ballpark for your subsequent question.

Q238 Rebecca Harris: My next question is: what effect do you think this shareholder activism had on short-term performance or the long-term outlook? What would you say was the impact of that?

Anita Skipper: It was a case where activism from disgruntled shareholders had an effect, because there is now a new chairman, a new CEO and a review of the business. This is activism in practice.

Q239 Rebecca Harris: So it benefits long-term performance?

Anita Skipper: That is why shareholders would do it.

Rebecca Harris: So it has an impact?

Anita Skipper: Yes.

Chris Hitchen: The important thing is to create a climate where companies are well governed, and so our interventions are not so much a kneejerk to say, “We do not like you or this particular thing.” It is more to create a climate where people are encouraged to do the right thing. In our own case, we are routinely voting against around 40% of remuneration policies, but it was pretty much the same before the shareholder spring.

Anita Skipper: It was.

Steve Waygood: In terms of our own voting levels, they are similar. One of the things I would also highlight, given that you have raised incentives, is I very strongly welcome Kay’s own focus on incentives within the system. The debate around the Shareholder Spring has, particularly last year, focused, possibly unhelpfully, on just board pay.

We have heard about a tip of the iceberg already, but pay is the tip of a different iceberg. The supply chain of capital has many intermediaries within it, so I think it is a very healthy conversation to be having around how one restructures broker incentives and how one restructures fund manager pay. How are the incentives around investment consultants restructured so that the short-termism that you are analysing is reconsidered throughout the entire incentives of the supply chain?

Chair: We will be coming on to these issues.

Steve Waygood: This morning? I do have a specific point I wanted to highlight, so do you mean we will be coming back to them this morning in this questioning?

Chair: Make it now, if you wish to.

Steve Waygood: Thank you very much, Chair; I appreciate that. We have been working with Tomorrow’s Company to produce something called Tomorrow’s Capital Markets.

Q240 Mr Binley: You are not selling to us, are you?

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Steve Waygood: It is free. We have sponsored this study and made it freely available. We are inviting other fund managers, other consultants and other brokers to work with us and Tomorrow's Company to open up how their incentives are structured and then try to establish how to include questions of stewardship and good ownership within that area.

If I can make a general point, our industry spends a huge amount of time and money trying to analyse how well fund managers enhance returns—how we are adding alpha to our clients. There is very little time or money spent on the question of how we are doing good stewardship. Yet I believe that is an industry that can be measured. There surely should be ways of measuring the substantive performance around engagement and voting and interactions and how we have held managers to account for their own governance of the firm. There are not those measures and metrics.

There are a few areas, perhaps, where they are evolving. One area is the UN-backed Principles For Responsible Investment, which now has over \$30 trillion worth of backing. They have an annual assessment of their members' performance in this area, and there are elements of that assessment that could be harnessed to actually measure the performance in stewardship terms.

As a final point, Kay's review does not look at that. It does not look at how you measure stewardship. If we were to look at that, you would manage what you measure, and you would start to see a transformation there.

Q241 Paul Blomfield: Neil, you were talking a moment ago about the barriers, limitations and difficulties with engagement, but your website says that shareholder activism is fundamental to good corporate governance. How do you define shareholder activism and what do you think needs to change to improve it?

Neil Woodford: In brief, I would say that, if you think like an owner, you will be by definition actively involved in stewardship and governance of the company. If you believe that at the first disappointing piece of news or the first opportunity you can exit the shares and move on to something else, then you will never think like an owner, and therefore you will not be actively engaged with that business. Ownership is crucial—a sense of ownership on behalf of obviously the asset owners as well as the asset manager. You can behave like an owner by proxy.

Q242 Paul Blomfield: How do we get to the point where people are thinking like that? What needs to be done?

Neil Woodford: We talked about incentive structures, and what we need to do as an industry is to think more long term about our investments, and the failure in the industry that Kay points out so well is a product of excessive short-termism. The short-termism exists at almost every link in the chain that exists between saver and company. We need to tackle that short-termist culture in each segment of the chain. Asset managers need to recognise their ownership responsibilities more readily. The intermediaries who

represent the savers, the clients, need to think about the incentive structures that they put in place, which create the wrong sort of behaviour in the asset management community. Regulation has a part to play as well—excessive regulation—and remuneration, of course, in the fund management industry. In the links in the chain, there are also issues that need to be addressed.

There is no one silver bullet; I agree with Kay that there is no one answer to this. Where we are today is the product of 20 or 30 years of market history and regulation, and it will take a long time to get to a better place. To my mind, there is no single thing that can deliver that outcome, but lots of little things can encourage the right sort of behaviour over time.

Anita Skipper: FairPensions' clarification of fiduciary duties could actually help here, so long as the result of the Law Commission's work goes in the right direction and says it is a duty for owners to think long term, but if it does not, then we start all over again. Basically the whole chain has to have the same sort of basis of duty, right through from the ultimate owner to the company.

If you start with a pension fund who has a duty to be long term, that will then filter through to the fund manager, who will then engage on a long-term basis, and then it will affect the company and allow it to have long-term shareholders. Until that alignment is there, you will have all the short-term investors coming in and becoming too much of the critical mass. We are not saying that everybody needs to be long term, but what we are saying is that we have not got a sufficient critical mass of long-term investors.

Q243 Paul Blomfield: Can I come to one of Kay's specific recommendations? As Neil says, there is no one silver bullet, but one of the specific recommendations is the investors' forum, which has been welcomed. However, when we met Lord Myners, he was supportive but sceptical that it would have an impact. Chris, today you have defined its role quite narrowly.

Chris Hitchen: I tried to explain the thinking that occurred.

Paul Blomfield: I wondered what you all felt about the investors' forum in terms of addressing some of these issues.

Chris Hitchen: I have explained the thinking that the Advisory Board had around it. It is easy to be sceptical about it. As I have said, initiatives have foundered before. I do think Lord Myners is someone who could make it happen, as it happens, but that is a matter for him. We did see it very much as providing a safe environment for investors to come together to engage on particular companies and issues.

Q244 Paul Blomfield: Is that how everybody else sees its role? Do Neil, Steve and Anita see the role in that way?

Neil Woodford: As a practitioner, I would say investors are not good at coming together and talking about investment issues. Corraling investors is a bit like herding cats. It is very difficult to get investors even to agree to meet on a particular subject, even if it is particular egregious.

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Chris Hitchen: They are scared to meet, because the FSA or Takeover Panel might be suspicious.

Neil Woodford: That is one of the principal reasons why investors are reluctant to communicate with each other. I have had umpteen examples of trying to pick up the phone to CIOs in rival fund management groups, who have expressed encouragement but little more than that and wished me luck in a particular endeavour. I believe a lot of other things need to happen alongside an investors' forum to get the best out of an investors' forum. On its own, I do not think it will achieve very much. If other things were put in place around it, I think an investors' forum could be really beneficial.

Q245 Paul Blomfield: Could I press Chris a little bit more on it? The way you describe it is almost as a tool for crisis intervention as opposed to something that could actually shift the culture and approach that Neil was talking about, and I just wondered how the rest of you felt about that.

Chris Hitchen: Sorry, are you pressing me or the others?

Paul Blomfield: I would welcome other people's views, but could you just come back?

Chris Hitchen: We are all in better shape as regards having generally improving standards—ratcheting up codes and those kinds of things. Business as usual day to day is less in need of a specific intervention. It is really how to deal with a particular takeover or whatever it might be, where we could probably get a better outcome if there was a safe place for people to talk about it.

Anita Skipper: Part of the reason why there is not much enthusiasm at the moment is that it has not been defined. People are not sure what this forum is supposed to be doing over and above what already happens. We think there is potential and the forum can add a lot of value.

Q246 Paul Blomfield: How do you want it defined to do that? Steve, you might be going to answer that.

Steve Waygood: Yes, absolutely. As has been alluded to by everybody, there have been a number of attempts to do this before. What is different this time? Why should the industry stand up and supply more stewardship simply because it has been suggested by a review? For me, one of the key questions is how much resource that forum, or those fora, will have. I do not think it necessarily needs to be just one forum. I can certainly envisage a very positive role for the forum that is being discussed by the IMA. I would encourage the market perhaps to supply more, and for there to be a competitive environment. There is nothing de facto about a forum that means that collaboration will be more effective or efficient and lead to better portfolio decisions.

Fora can be extremely bureaucratic and ossify our ability to engage; they do not always necessarily work well. The ones that work well are the ones that are well resourced, and we have a proposal for that. It actually touches on the submission that Lord Myners made to you too, where he was talking about how research commission could be allocated.

Very simply, I have two budgets that I can call upon. One is the budget that pays for the people in my team, so that comes from our P&L as a firm—from Aviva Investors' own bottom line. There is also research commission, and that commission is generated every time we make a trade on our clients' portfolios. It is our clients' money that generates that commission, and roughly about 0.15% of every transaction is a commission. Two-thirds of that, if it is a large UK company, is funding research in the sell-side, so brokers.

I believe if we were to create an enabling environment across the City that encouraged—not required, but encouraged—fund managers to allocate a proportion, let's say 10% to 20%, of their research commission towards stewardship, meaning brokers analysing the quality of governance, the quality of the sustainability strategy of the company and its business ethics, then I think you would see tens of millions of pounds more funding good stewardship work. I would envisage at least one of the investor fora, if not many, being fundable through that way. Why shouldn't independent research cover stewardship? Why shouldn't it cover corporate governance?

At the moment, the point to emphasise is that many of my peers within other fund management institutions do not use their research commission pot of money to invest in this way. We do; Aviva Investors does. But I know a lot of our compliance colleagues in other firms are hesitant. You will have seen the press today looking at corporate access as an issue, so understandably you have very hesitant compliance teams.

A transformative proposal is embedded in one of Lord Myners's suggestions, which is to enhance the use of research commission for stewardship. That has not been considered in the Kay Review: how would you finance the forum? How would you fund stewardship? I find that an odd anomaly, given that clearly we are talking about an area of economics.

Q247 Chair: This is a very significant suggestion that you are making. Chris, if I can put you on the spot, why did Kay not make any observations on that?

Chris Hitchen: On the way it should be funded? Professor Kay devoted basically a year of his life to the construction of this report, and I think most commentators would agree it is an extremely elegant and accurate picture of the world we find. As Neil said earlier, the solutions are not easy to find, and I would agree that if the pendulum spent 30 years swinging this way, it is going to take 30 years to swing it back the other way.

Q248 Chair: It seems odd to the layperson that an exercise that took so long should not actually make that many positive recommendations at the end of it, particularly when we have just had one here today that would seem to be, if you like, waiting there to be introduced.

Chris Hitchen: I did not write the report. I can speak for the discussions we had around the Advisory Board. Ultimately, if we had had another six months or a year, we might have gone further into the

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solutions, but I think Professor Kay felt that other people would come forward to do that.

Chair: I will bring you back in, Steve, then I will come back to Paul, because I am conscious that we are running behind time.

Steve Waygood: Just very briefly, this is an idea that has come to us through reading the Kay Review and participating in the conversations afterwards. We did not submit it whilst Kay was considering his evidence, so it has been inspired by these conversations.

Chair: We will see Kay as an inspiration. I believe Paul has to leave soon.

Q249 Paul Blomfield: Let me just pursue this a little bit more, moving away from the investors' forum and looking at the other options that Neil was talking about. Kay talks about the two choices facing investors as voice or exit. In what other ways can we do more? In what ways can Kay's principles be implemented to encourage more investors to choose to change weaker companies rather than simply sell on?

Steve Waygood: The demand for stewardship: the suggestions that we have made around how consultants could be encouraged to measure stewardship, and how consultants could then be encouraged to advise their clients. It is not just pension schemes; I should also highlight that insurance companies of course own a considerable amount of the UK stock market. It is a matter of introducing standards and measures of good stewardship through the supply chain and the oversight chain and enhancing the financial literacy of the end investor, so that their IFAs, the Individual Financial Advisers, are also encouraged to scrutinise retail fund managers as well.

There needs to be a series of interventions in the whole chain—the demand and the measurement of stewardship. That goes for brokers too. One could require of a broker in their detailed notes on companies to offer a view on the corporate governance. It is exceptional when they do, these days; they do not.

Neil Woodford: Incentive structures are really important around performance measurement and the hiring and firing of fund managers like us. If those incentive structures were shifted to a longer term perspective, that would be a very important step in encouraging longer term behaviour and more engagement, i.e. voice over sale.

Chris Hitchen: That is true both of the fund managers and of the company managers. Arguably, long-term share ownership is the best way to align the interests of the company management with those of the investors. Similarly for the institutional investors, or rather their agents, I would like to know that their long-term remuneration is going to be broadly aligned with the needs of my members. So that is a key point. It is about defining what success is as well. Success should not be about beating the market today and beating the market tomorrow. To an extent, that makes it incumbent on us as trustees and trustee representatives to find different ways of measuring success. It would probably have to be more around, "Have you contributed real value to my pension

schemes' assets over many years?" rather than, "Have you beaten the market last quarter?"

Chair: There is a danger that you start debating amongst yourselves, and I realise that when you have got like-minded people all interested in the same thing, that can happen.

Paul Blomfield: Neil was agreeing, were you not?

Neil Woodford: Yes, I was agreeing.

Chair: I am conscious of the fact that we are running way behind time, and we have got another panel, so can I bring in Caroline Dinéage now?

Q250 Caroline Dinéage: Steve, and Anita as well, you have mentioned stewardship quite a lot this morning, and it is something that we have heard a lot about. Do you think the code is fit for purpose and what changes would you make to it?

Steve Waygood: Yes, we do. I am disappointed with the number of pensions that have signed up to the Stewardship Code. One of the proposals that we made earlier was around how we could finance stewardship through research commission. Personally, if I was rewriting the Stewardship Code, I would add a provision in there encouraging those people who sign up to the Stewardship Code to examine how they use their research commission to promote and finance stewardship. I could carry on, but those would be the two biggest things for me.

Q251 Caroline Dinéage: What incentives are there for the industry to take these codes on voluntarily?

Steve Waygood: Comply or explain matters. We have seen it work well in the UK corporate governance listed environment for plcs. It only works really well if the people who are being explained to read it and then feed back to the people who wrote it what they think. That is the bit that is missing. In the UK corporate environment, there is an AGM and a series of votes at the AGM that enable the owner to then communicate formally back to the company. Of course there are in between times plenty of meetings too that enable that to happen. We have the meetings in the investment world—we meet our clients—but we do not have a formal opportunity for them to say what they think about our Stewardship Code. The oversight bit is missing with comply or explain.

Anita Skipper: It goes back again to the demand side of it, because if you are not complying with the code and you have not got your name on the FRC website and nobody cares anyway, then nobody is incentivised to do it. What you need is an environment where complying with the code is something that is seen as a good thing and that everybody is supposed to do, but we are not there yet.

Q252 Caroline Dinéage: How long do you think we should wait to see if firms volunteer to take on the code before we insist on legislating them to do so?

Anita Skipper: A lot of fund managers have already signed up. The disappointing bit is that the owners have not signed up. You want the owners to sign up so that the fund managers actually do the work for them. Fund managers do see the benefit of engagement, which is why Neil spends so much time engaging with companies, but it is very difficult to

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keep increasing that when nobody is asking you to do it and they do not even care. The focus must be on demand from our perspective.

Neil Woodford: On its own, I do not think it can achieve what it sets out to achieve. We talked today about lots of little steps to encourage different sorts of behaviours. On its own, the code is a splendid document. Our Stewardship Code is a splendid document. But even within my organisation, I doubt whether many of the fund managers who are engaging with companies have even read our Stewardship Code, let alone implemented what we say we do. So there is a certain amount of paying lip service to it. We have evidence there it is sort of a box-ticking mentality to a certain extent.

Again, coming back to what I said earlier, you have to think like an owner before you can take those Stewardship Code responsibilities seriously and implement them in how you run money for your clients.

Q253 Caroline Dinéage: Would you advocate some kind of compulsion, then?

Neil Woodford: I am instinctively concerned about too much regulation. Kay talked about this again in the review. Regulation is encouraging the wrong sort of behaviour, so more regulation may not be the best way to go, or if there is more of the right sort of regulation, there should be less of the wrong sort of regulation commensurate with that. I am nervous about too much regulation but, in and of itself alone, it will not deliver what we want it to deliver. Behaviour has to change over time with a whole structural change in terms of incentive structures in the industry.

Anita Skipper: What I think has made a big difference is just the publicity this has all got in the press every day. That has started the momentum towards much more awareness of stewardship and long-termism. It would be helpful to be able to keep that profile until we actually achieve whatever it is we are trying to achieve.

Q254 Caroline Dinéage: Can I move on to Chris, please? The pension industry will soon be seeing a massive expansion due to the auto-enrolment scheme. Do you feel that the industry is ready for this, and what changes are being made to prepare for the new clients and funds?

Chris Hitchen: I perhaps should declare I also happen to be a trustee of NEST, the new Government-sponsored pension scheme, which will be one of the vehicles used for auto-enrolment. We are seeing the potential emergence over the next decade of a relatively small number of large players in the defined contribution world. There is a reasonable chance, particularly with initiatives such as Pensions Quality Mark, which I already mentioned, that those will in the main be well governed, whether through trustee structures or other means. It could be a way of ensuring that UK institutions do have that scale, which in the main they so far lack. The long-term picture might—provided those institutions are allowed to get off the ground—be better in terms of ensuring that savers are appropriately represented.

Chair: Can you address your remarks to us rather than fellow panellists? Have you finished now, Caroline?

Q255 Caroline Dinéage: Just very briefly, do you think that governance and stewardship practices in the pension fund industry need to change to accompany the greater influence that pension funds will have in terms of their market share?

Chris Hitchen: As I said earlier, there is a dip at the moment; pension funds have been on the wane, and it is going to be a while before the new schemes really rise again. There are constantly advances in technology, and certainly at NEST we are thinking very hard about how we ensure that there is direct engagement and information available to scheme members, whilst still remembering, as I said earlier, that we have to do what is in their best interests, rather than what they might actually want us to do.

Q256 Katy Clark: Short-term shareholders can influence mergers and acquisitions, often forcing decisions on longer term shareholders that perhaps they do not want. Do you think that short-term shareholders should continue to have the same voting rights as those with perhaps a longer term interest in a company?

Anita Skipper: Yes. I think that the “one share, one vote” principle is the fairest principle. There are too many problems once you start giving out differential voting rights, and things that are not actually supportive of what we are trying to do here. You could entrench management whom you are trying to persuade to change what they are doing. Because of differential voting rights, they are entrenched. So there are lots of reasons. It is practically quite difficult as well, so we would prefer other means of actually making things more long term.

Q257 Mr Binley: Can I pursue that? Can I refer to Cadbury? That was a pretty glaring example of short-termism in takeover situations. I wonder whether we ought to be crude enough to say, “You have to own shares for three months before you can vote on the future of the company”? Is the only way to deal with it a very crude line?

Chair: The takeover code has basically kicked this into the long grass.

Mr Binley: Yes, and I would like you to think again about it.

Neil Woodford: The subtext here is that the market in corporate control should be controlled. I am instinctively reluctant to agree to that.

Q258 Mr Binley: We are just talking about those people who can vote in a takeover.

Neil Woodford: Cadbury was sold in the end because the long-term shareholders accepted.

Q259 Mr Binley: Cadbury was sold in the end because they were bullied to sell in the end; let us be perfectly true with it.

Neil Woodford: Cadbury’s shareholders decided that the price that was being offered was attractive enough for them to want to sell their shares to the bidder. It

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is a simple law of economics that dictated the outcome of that particular bid, as in most cases.

Q260 Mr Binley: You are perfectly happy with an American hedge firm being more involved in British industry than they perhaps should be.

Neil Woodford: That is not what I said. What I said was that the long-term shareholders who owned Cadbury decided that the price that was being offered was attractive enough for them to sell their shares, because there is always, of course, an opportunity cost associated with investment. You can take your capital from your particular investment and deploy it more productively elsewhere.

Q261 Mr Binley: I think that is a very kindly view of what happened there. Are you telling me that you do not think that there ought to be a time limit before you are able to vote on the future of the company? Shouldn't you have some involvement for some time before that happens?

Neil Woodford: I am not saying that necessarily. All I am saying is that it was the long-term shareholders of Cadbury who dictated the outcome of that company's fortunes. It was not the hedge funds. They sold in the market to them—to the arbitrageurs.

Q262 Mr Binley: They had no alternative, but never mind.

Neil Woodford: They had alternatives.

Q263 Chair: We could probably hold a separate enquiry into this, and in fact we already have done. The basic point, leaving aside the Cadbury issue, is whether there is an argument for restricting the ability of short-term investors to intervene in a takeover situation.

Chris Hitchen: Just very briefly, I think there is a case for looking at whether you should be able to borrow shares to vote, and that is something the Government may wish to think about, and there are different ways you could address that.

Chair: Can we move on? I have got Julie Elliott now. Some of these issues have been covered, so please pick out those that have not.

Q264 Julie Elliott: As a matter of procedure, what steps do you take to check the suitability of companies that you invest in? Specifically, what do you look for when checking the companies?

Neil Woodford: How long have you got?

Chair: Not very long.

Neil Woodford: When you are analysing companies ahead of making an investment decision, the process never ends. You never stop analysing them when you have invested. If anything, the intensity of your scrutiny increases. You look at a whole host of things. Ultimately, an investment decision is really about value discovery. Kay talks about this in the review.

My job is really as a value hunter. I am looking for undervalued situations in the market. The most attractive or the most undervalued situations are, by definition, the best investments. The whole process of investment analysis is really about identifying

undervaluation—the mis-pricing or the mis-valuation of assets.

Q265 Julie Elliott: Do you think you are quite successful at doing that? Do you think companies are good at doing that?

Neil Woodford: Companies?

Julie Elliott: Well, organisations.

Neil Woodford: I think the track record of fund managers speaks for itself, broadly, in that when you measure the average fund manager, he does not beat the index. In many respects the industry falls down, but of course by definition the average fund manager will not be able to beat the index; we are, after all, contributing to the index. There are examples of fund managers consistently beating average returns. You have got to measure those returns over a very long period of time. As I said right at the start of this process, I have been managing the same fund for 25 years, and if you want to look at the long-term track record of that, I encourage you to do so.

The fact is, it is possible to deliver superior long-term returns, but you have got to have the right approach and focus on value discovery rather than—as we have talked about all day—the obsession with price over value, for example, which is inappropriate. It is possible to beat the market; it is possible to justify your existence and undertake your socially useful functions as well in improving the performance of companies and benefitting the economy in the process. The industry unfortunately is not set up sufficiently well to deliver that outcome. That is why we are here today.

Q266 Julie Elliott: Would everybody agree with that?

Anita Skipper: Following on from what Neil said, once you have made that decision and you have bought into this company and it is a strategy that you like, the ongoing engagement is whether they are sticking to the strategy, whether the people who are actually running the company are competent to run it and whether they are going to stray from the strategy. Quite often we get involved with the fund managers because the company is doing something that we had not bought into and it is a surprise. That is why, once you have made a decision, as Neil says, it is an ongoing thing, and in fact your scrutiny gets even greater as time goes on, because it is even more important then. You have spent all this money, you have held it for many years in this company, and you want the returns at the end of the day.

Steve Waygood: The only thing I would add to what has been said before is that, going back to the first question at the beginning of this meeting, one of the transformations that we have seen in this industry over the last 10 years is that very large organisations like Bloomberg, MSCI and Thomson Reuters are now adding to the conventional financial metrics qualitative views on the governance of the firms and their sustainability: how they deal with their customers and how they deal with their employees. It is beginning to be possible to enhance the qualitative view of the company with these metrics from, for example, Bloomberg.

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In the last three years, we have been very actively adding various measures of the integrity of a firm to our security selection process, portfolio construction and portfolio risk management. I am not pretending for a second that we have finished or we have got it 100% perfect, but what it adds to the view is interesting. It really does deepen it. It is an odd observation that Aviva Investors is one of the very few firms to have done that systematically. What is good is that the likes of Bloomberg now cover this.

Q267 Julie Elliott: Would you say that this extra information has made a difference in terms of the companies you invest in?

Steve Waygood: Yes, it does. Often it reinforces what was the fund manager's view already, and you would expect them to align, if you like. But where there is an anomaly—a company that has good financial prospects comes through MSCI's intangible value analysis tool with a ranking of triple C, which is very bad—that gives us an opportunity to then have a conversation with the fund manager about why it is ranked like that. It could be that we might sell down the holding, so the exit, or we could engage: the voice that Albert Hirschman talks about and that Kay uses as a key reference. There is a lot more to do. If you wanted to come and pay us a visit, we would be very happy to take you through the process.

Chris Hitchen: It is fair to say that we are talking about one particular kind of fund management, and there are many other kinds of fund management.

Chair: We need to move on.

Chris Hitchen: One very quick point: there are many reputable companies that use quantitative techniques, but many shares are actually traded by computers doing high-frequency trading and that is a million miles away from what we are talking about today.

Chair: We have covered that with other panels, and to a certain extent we will go on to that.

Q268 Nadhim Zahawi: A quick question to Chris. You are a member of the Kay Advisory Board. What advice did you give Professor Kay about the balance between voluntary best practice and formal legislation?

Chris Hitchen: All of us agreed that, if you can get the market to produce good solutions, that is usually preferable to regulation. However, we did feel there were areas where the market has had 30 years of going in the wrong direction, as we have said, so some Government nudging to push it back in the other direction is probably necessary at this point. There are 17 recommendations in the Kay report. A few of them ask Government to do things, but there are actually more that ask other people to do things. Government should do the things that we asked them to.

Q269 Nadhim Zahawi: What recommendations fell away from the 17 that you may have discussed that you would want the Government to do?

Chris Hitchen: Where did we fear to tread?

Nadhim Zahawi: Slightly.

Chris Hitchen: As I have already said, we only had limited time. Professor Kay in particular spent a year of his life on this but did not have any more time to

spend on it. One area that perhaps does not come out as much in the report, although it is there, is around the potentially perverse effects of high-frequency trading and what happens on the sell-side. Around the table we were reasonably well disposed towards a financial transaction tax, which might help to mitigate that. We did not pursue that, but it is something we definitely picked up.

Q270 Nadhim Zahawi: Why didn't you?

Chris Hitchen: We had limited time and we were also aware that it might be an area that would need quite a lot of work with Government to get all sides of Government lined up behind it. I am not an expert on this matter.

Q271 Nadhim Zahawi: That is not a good reason for not pursuing it—that it required more work. You could have suggested that that is what needs to happen.

Chris Hitchen: Sorry. Professor Kay has already been before you, I think, and has probably already touched on this issue. We were minded to think it was a good idea. There are problems with imposing any sort of tax on a partial basis in a global market, so that was one reservation we had. Frankly, we were also aware that there was a potential short-term detriment to UK plc in doing things to hurt the City, and we had to be cognisant of that.

Neil Woodford: We already have a financial transaction tax.

Chris Hitchen: We do on end investors, but not on professional investors. It is the wrong way round.

Neil Woodford: Yes, it is the wrong way round.

Q272 Nadhim Zahawi: So you are in favour of a financial transaction tax if it is implemented globally. Is that what you are saying?

Chris Hitchen: It could potentially take a lot of unnecessary trading out of the system. Who pays for the profits of traders? Ultimately it seems to me it is the end investors; it is my members. Even if we end up paying a small tax on the trades that we do, if it stops us paying for a lot of profits on other peoples' activities, then we are still better off, net-net. That is my view.

Q273 Nadhim Zahawi: Do the rest of the panel share that view?

Steve Waygood: I would be very happy to say "yes". We only agree that the financial transaction tax is a good idea if it could be done simultaneously in all key financial jurisdictions. Unfortunately the political practicalities of that mean that it might be an academically good idea for Tobin 30 years ago, but the current manifestation of it is not something that we would support.

I hope what I have been very clear about is our recommendation, which is similar in a sense, that we should use the existing commission. So not just have the commission there to sit as a brake on the system, but also hypothecate the commission itself, so that you are funding better stewardship. In fact, for me, there is nothing de facto that hypothecation will happen with the revenues of the FTT, and in fact the treasuries around the world have a very poor record on

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hypothecation. So that is one of the other reasons why we are not in favour of the FTT.

Chair: I am getting a lack of enthusiasm on the FTT.

Neil Woodford: It is going to be really hard to get the universal outcome that we want, so disproportionate FTTs would be damaging, potentially.

Q274 Nadhim Zahawi: Just very briefly, Chris, you mentioned the recommendations from Kay. Which ones do you think most naturally lend themselves to formal regulation?

Chris Hitchen: At the risk of repeating ourselves, we did feel that the investors' forum required some sort of Government backing, if only to get over the perception that regulatory authorities would be against this sort of thing. One thing that was touched on this morning as well was the question of fiduciary duty, and the extent to which that can be forced through the investment chain. At the moment it applies at my end

of the chain but it does not apply at the transactional end, and Government intervention may be required to prevent it being stopped from going down the chain by contractual arrangements. Those are the two I would cite.

Chair: That concludes our questioning. It is has taken rather longer than I expected. Thank you for your contribution. That is incredibly helpful, and I will finish as I finish with other panels by saying that, on reading the transcript of this, we may feel there are further questions that we would like to ask. We would be grateful if you could respond to them. Similarly, you may feel that there are questions that we should have asked but did not or that you would like to supplement the evidence you gave—feel free to write in to us. It will be incorporated in our final report. Thanks very much. Can we have the next panel, please?

Examination of Witnesses

Witnesses: **Daniel Godfrey**, Chief Executive, Investment Management Association, **Guy Sears**, Director, Institutional, Investment Management Association, **Penny Shepherd**, Chief Executive, UK Sustainable Investment and Finance Association, and **Matthew Fell**, Director of Competitive Markets, Confederation of British Industry, gave evidence.

Q275 Chair: Good morning, and thank you for waiting patiently. I apologise for the delay. One of the reasons for that is we had rather more questions for the previous panel than we have for you. However, that does not mean the responses you give may not generate further questions. Could I just start, as I did with the other panel, by asking you to introduce yourselves, and the organisations that you represent, for voice transcription purposes?

Guy Sears: I am Guy Sears. I am Director, Institutional, of the Investment Management Association.

Daniel Godfrey: Good morning. I am Daniel Godfrey, Chief Executive of the Investment Management Association

Penny Shepherd: I am Penny Shepherd. I am Chief Executive of the UK Sustainable Investment and Finance Association.

Matthew Fell: Good morning. I am Matthew Fell, Director of Competitive Markets at the CBI.

Q276 Chair: Thanks very much. I will just remind you, in case you were not here, of what I said to the previous panel. Some of the questions will be person specific, others will be general. Please do not feel that you all have to respond to every question if you feel that there is nothing really that you could add to what has been said by the previous speaker.

Can I start with a question to you, Penny? I will try to abide by my own strictures this time and be disciplined. In your written evidence, you state that UKSIF's aim is to "seek to ensure that individual and institutional investors can reflect their values in their investments". If Kay is successful, can you take your P45?

Penny Shepherd: Well, I am planning to take a P45 anyway. UKSIF supports financial services that

advance sustainable development. We see an effective market in good ownership practice by investment managers as an important way of ensuring that investment services can effectively advance the public good as well as meet the needs of their clients. That is in part about enabling people to invest in line with their values, but it is not only that.

It is fair to say that, increasingly, investors are looking at environmental and social and governance issues, because they give additional insights into financial returns and because they are increasingly material to the success of a company in long-term value creation. Ultimately, we are interested in stewardship because we see a greater emphasis on stewardship as a necessary technique for ensuring that capital markets serve the public good.

Q277 Chair: From your different perspectives of the equity market, what do you see as its primary function and its different players? Who would like to lead on that? Daniel, you look as if you have got a response.

Daniel Godfrey: The primary function of the equity market is to get capital from people who have it to people who need it in an efficient way. As to the role of the different players, the role of the corporate who is seeking capital is to promote the success of their companies, and we would see that in a more holistic sense than perhaps has been the case in the past.

By that I mean that the success of the company is to have a sustainable, long-term supportable company that delivers not only returns to its owners but also opportunities for development and growth to its employees, plays a responsible role in the communities in which they operate and takes a responsible attitude towards the environment, and so on. In terms of the other players, the players go all the way down the chain to the individual investors and

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pension fund members who are providing, effectively, the capital that goes up through asset managers and through the buy-side in the market towards the companies.

Penny Shepherd: One thing I would add to that is one of the most significant things about the Kay Review is that it challenges that question of the primary purpose of capital markets, and it highlights that the purpose of capital markets is to meet the needs of the end users of the system, i.e. the company's need for capital on the one hand and the saver's need for appropriate returns for providing that capital on the other.

Over the last few years, the purpose of regulation of capital markets has been to ensure that the capital market works smoothly for the participants in the market. So it is a really significant shift from, "Does the engine work smoothly?" to "Does it actually get you from A to B?" That is a really important difference.

Q278 Chair: A previous witness—I think it was Lord Myners, and I am paraphrasing him—said, in effect, "Is the City here to serve the economy or is the economy here to serve the City?" What is your view on that? Penny, from what you said, I gather you think that regulation has reinforced a self-serving element of the City. I may have misinterpreted that, but I think Daniel wanted to respond first, and then Penny wanted to come in.

Daniel Godfrey: If you take the purpose of investment management, the relationship there is that clients, whether they are intermediated or direct, effectively give asset managers their money and trust them to use their skill, knowledge and experience to invest it in a way that will deliver them returns in a risk-appropriate fashion. Asset managers do not take money on to their own balance sheets, and that gives them a fiduciary purpose that they need to always be aware of.

I would say very much that the purpose of asset management is to look after the interests of clients, to allocate capital efficiently throughout the market and to do the best possible job they can. You asked whether the economy is there to serve the City, and I think there is no doubt that there has been a lack of balance in the relationship between society and the City in recent years. That is something that the industry, the Government, the regulators and society need to sort out, and this is part of that process.

Guy Sears: On the equity markets and Kay saying, "Do they actually serve the purpose?" there is a distinction in language. The equity market as an economic whole is there about the allocation of capital. The precise mechanisms used on the trading venues at the moment and in the structure of the stock markets—I think this is one of the things Kay talks about—are as much intermediaries with their own incentives as any other part of this chain. Sometimes they are not seen in that way, but they are. They have incentives that maybe drive tariff into types of trading that are not really serving this longer term interest.

Matthew Fell: I would just endorse what was said on the role. The provision and efficient allocation of capital has to be at the core of the function, and on

the second issue the answer surely has to be that the City is there to serve the economy.

Q279 Nadhim Zahawi: We have heard that it is common practice for fund managers to vote on company matters without consulting their shareholders at all. Does this practice need to change?

Daniel Godfrey: There are a wide variety of different clients. You are talking about whether they consult their clients and end users about how they vote. Clearly, it is the right of a client to tell their supplier how they wish that relationship to be governed. If a major pension scheme says to a fund manager, "We want to dictate how you vote on any issue," then the supplier should say, "Absolutely, yes. But, of course, we want that to be taken into account when you measure how well we have done, because if you have voted yes on something that we would have voted no on, and then the whole thing has gone pear-shaped, do not come along and kick us for the underperformance of that holding." That is just the nature of commercial relationships.

You got into a bit of a debate with Neil Woodford about consulting the hundreds of thousands of individual investors. There is a demarcation between communication and control. It would be utterly impractical and probably not a great thing to set up some sort of internet voting mechanism, where every one of Neil's hundreds of thousands of clients could push "yes" or "no", and Neil would then vote accordingly. I do think that communication with your customers about what your process is and what you have actually done in principle is absolutely the right thing to do, and we should seek to move that forward. I was interested in that part of the debate, because it must be 25 years ago that I set up one of the first ethical investment unit trusts in this country. Around that trust we put together an independent panel to look at the investments that the managers were making to see that they met the criteria, and we did have an annual general meeting whereby investors could come along and complain: "You have bought this company and they sell tobacco somewhere," or whatever it was. I felt that engagement was very helpful.

I think engage, yes, make decisions, no. In principle, when you hire an asset manager you are delegating to them the responsibility to buy and sell investments. Part of that probably should be by and large the engagement and the buy/sell decisions. Otherwise, how do you measure their performance? We need to have a much better understanding; we need to have much better practice; we need to have much more frequent practice; but ultimately you as a client should be choosing an investment manager because you like the way they do it, rather than trying to stand on their shoulder and dictate voting for them

Penny Shepherd: Building on that, in many ways I would endorse what Steve Waygood was saying earlier—that the key issue is around demand and around valuing good active ownership by investment managers. In many ways your question might be reinterpreted as the value of representative democracy versus the value of direct democracy.

At one level, to throw the question back, I would ask how helpful is it when your constituents tell you

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exactly how they would like you to vote on a particular vote in the House. The answer is that you are probably glad that they are showing an interest in the particular issue—you are glad that it is showing demand for your services as a representative—but at the same time you probably recognise that you have a depth of knowledge of that particular issue that not all the individuals who are telling you how to vote will have developed.

What we are concerned about is increasing that demand. One way UKSIF is seeking to ensure that is by co-ordinating the UK's first Ownership Day next week to raise awareness of the issue, because we are really conscious that, if you read the personal finance pages, it is all about how to pick a good stock picker. It is never about how to pick someone who is good at stewardship. I mean even if you look at the press coverage around Neil Woodford, it is very rarely about Neil Woodford as an active owner; it is much more about Neil Woodford as a stock picker. That is typical of the environment at the moment.

However, what we are saying in Ownership Day is, "Ask your fund manager what they are doing, because in many ways they are the experts." What our fund management members say to us is, "If an individual emails us and says, 'I would like you to vote a particular way with my shareholding,' actually that is welcomed." It is a demonstration of interest and not a lot of emails like that get sent—considerably fewer, I think, than the emails you receive about individual votes in the House.

Daniel Godfrey: You have reached the real nub of it in many ways when you talk about demand, because demand ultimately will be driven by belief, and the belief needs to be as to whether it adds value. Are we going to get better long-term outcomes by having good stewardship and engagement, or are we not? I guess your belief is that we will; I believe that we will. The evidence shows that we will.

But until the clients believe it, and believe it is worth paying to get it, what you are going to get is some people who really believe it, as you saw with Aviva, and who do it that way because they believe in it, and other people who do not really believe it going through the motions. That is why you get the box ticking and the boiler plating and the establishment of a patina of activity to defer attention from the press or the regulator or Government or politicians. That is why there is a very big education process required to bring people into the tent to put the spotlight upon them, and to convince people that this really adds value for the longer term. Otherwise, it is not going to really work.

Q280 Nadhim Zahawi: The reason why this is an important issue, and I will come back to Penny's point about reversing the question to us, is that some will do it really well. It is a bit like this place, where some politicians have embraced the new technologies and communicate with their constituents regularly and consult them regularly on how they should behave in this place. That is a good thing, and the same thing will probably happen in your industry, in the sense that those who will do it really well will flourish and do well in the new world. Those who do it badly will

be found out, and those that do it as a box-ticking exercise will also be in a less comfortable position.

In terms of reversing, I slightly disagree with you. Yes, of course, demand is a challenge, but it is how you communicate in the first place—how you consult. I do not think it is a black and white issue of either saying, "Well, we are going to let them vote the shares and I am going to behave the way they want me to," or, "I just send them communications," as a one-way broadcasting exercise.

There are many more innovative ways today, whether in politics or in your industry, of consulting properly, i.e. setting the rules out to people saying, "Here are the trade-offs; here are the things I am thinking about"—because they are ultimately the experts—"What do you think?" Then the data comes back to you, and then you can act on that data. I do not believe you should not act on the data at all, and you should just say, "Well, they have bought into me because I am the expert and that is it." There are many better ways of doing it than this—forgive me for saying this—sort of old-school thinking.

Chair: I think we have got the message. Could you respond?

Daniel Godfrey: I think we agree that communication should be two-way, and it informs your decision-making just as your constituents may inform yours, but ultimately they have elected you to come to the House to cast your vote according to what you believe. It is a very good analogy to the fund manager, and the two-way communication needs to exist.

Penny Shepherd: Can I just add one brief point to that? One area in which this House can act to raise awareness is by acting as an exemplar of good practice. In particular, I do hope that you will encourage the Parliamentary Contributory Pension Fund to be an exemplar of good practice in this area. I certainly think from my understanding that there are opportunities for improvement there.

Nadhim Zahawi: That is a very good point.

Chair: That is very well put, if I may say so.

Q281 Nadhim Zahawi: My final supplementary: obviously, part of the problem is that fund managers have so many companies on their books, so practically how can we combat this over-diversification do you think?

Daniel Godfrey: The investors' forum could potentially be a way of helping with that. I recognise that it is very hard to get a consensus amongst investors, as Neil Woodford told you earlier. There are examples, for instance in Holland, of where organisations come together effectively to syndicate from the buy-side their research on stewardship and engagement and governance, so that you can spread the load across a broad number of investors. That could potentially be a role for the forum that Chris and Professor Kay had not envisaged.

In our discussions with investors, although it is not a universal theme, that has been raised by a number of them. People are saying, "Look, we cannot bring our A-game to every company that we own, because we just own too many of them. Is there some way in which the forum could enable us to come together to spread the load, so that the people who have either the

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highest motivation around a particular company or the greatest skin in the game could effectively be deputed under a philosophical framework about what good engagement and stewardship looks like, so that we can trust them to go and ask the right questions?"

Guy Sears: A key point, so it is explicit in what Daniel is saying, is this is about mechanisms for addressing the consequences of diversification, rather than suggesting people should not be diversified. It is very important we do not forget that the economic advantage of being diversified in a fund and suchlike is a very considerable one. There is just a cost that comes with it, and we are trying to address that cost, rather than suggesting you should not be diversified.

Q282 Mr Binley: A simple question to Mr Godfrey, primarily. You have launched a discussion about setting up the investors' forum. Can you tell us what progress you have made?

Daniel Godfrey: Yes, certainly. I would say there have been varying shades of enthusiasm as we have discussed it around the industry. We have tried to talk as broadly as possible, because we recognised one of the very valid points Professor Kay was making was around the fact that a decreasing proportion of the UK market is owned by traditional UK institutional investors. Foreign investors and sovereign wealth funds own an increasing proportion. We have talked to insurance companies, pension funds, investment managers, sovereign wealth funds and foreign investors. As I said, there is probably a spectrum of enthusiasm that ranges from highly enthusiastic to pretty much opposed to doing anything.

There are grounds to say there is already a lot going on; there are a number of informal forums that do work in some circumstances at getting people together and making things happen. The view that we expressed in November was that we felt that a formal mechanism with a thin layer of resource to actually drive the thing forward and do some of the heavy lifting would help. I would say that the majority opinion, in my view, would be fairly lukewarm support for the idea that, if we do not give this a really good go, we will never know whether we can make it work or not. We will seek to proceed from there if we can over the next few weeks.

Q283 Mr Binley: I am delighted by your display of enthusiasm; it is very commendable. You talked about foreign investors and sovereign wealth funds. How many foreign investors and wealth fund people have signed up?

Daniel Godfrey: We are not asking people to sign anything at this stage.

Q284 Mr Binley: So you are still in the preliminary stages then?

Daniel Godfrey: Yes, we are still in the preliminary stage of seeing if we can establish a sufficient consensus to bring forward some concrete proposals to make it happen.

Q285 Mr Binley: What is your target date for the first meeting?

Daniel Godfrey: The target date for deciding whether we have a sufficient consensus to move forward to the next stage will be over the next few weeks. What I wish to do then, if we are able to move it forward, is put this in the hands of actual investors—to take it away from the bureaucrats within the trade associations—to take forward the ideas and the information we have gleaned over the last few months and to ask them to take this forward to the next stage. But we would provide the secretarial and, if necessary, financial support to make it happen.

Q286 Mr Binley: What would be your target for setting this thing up, rather than talking about it? I admire your enthusiasm, but I want to know when it is going to happen.

Daniel Godfrey: If we are able to move this forward, I would think in the next four or five months that you would want it to be up and running.

Q287 Mr Binley: We shall track that, and that is encouraging. Can I just ask one final question? Lord Myners was pretty scathing, and the fact that you mentioned you want to hand it over to the trade, as it were, as opposed to trade organisations, suggests that you read those remarks. But if you did not, let me read out his fear: "What we will end up with is a forum that is dominated by trade associations, and trade associations' modus operandi—their purpose for existing—is to protect the status quo."

Daniel Godfrey: I could not disagree with Lord Myners more. I agree with him, though, very much.

Q288 Mr Binley: I will write to him and tell him that.

Daniel Godfrey: You do not need to; I have told him myself.

Q289 Mr Binley: You have done it yourself?

Daniel Godfrey: I have told him myself. Our vision of what is needed is actually quite similar, and Lord Myners has a very good way of expressing himself.

Q290 Mr Binley: You thought he was being naughty, did you?

Daniel Godfrey: I would not say that. I have seen worse.

Q291 Chair: There were elements in your response to Brian Binley's question that smacked of Sir Humphrey. Having a consultation to achieve a consensus and then moving it on. I mean are you actually driving this process with any sense of conviction? Was it delegated to you to take on—not you personally, but your organisation?

Daniel Godfrey: I had only been in position for a very short amount of time, so this is something very much I wanted to grasp, because it is something that I strongly believe in. There is definitely a sense of conviction behind this.

The subject of stewardship and governance needs to be elevated above the primary focus on issues around the board and issues around remuneration, which I acknowledge are very important. We need to look at stewardship as being around a real understanding and

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support by investors of companies' long-term strategies for sustainable shareholder return. It needs to be about understanding and support of the companies' management as being people who are capable of executing the strategy. It needs to be around an understanding of the companies' financing models, so that they have the resources necessary to execute on the strategy.

That is all very clear, but to get to your question, it is not easy, because there are a lot of different views. As Neil Woodford said, if you have 10 investors in the room, you will probably have 12 different views. I have to be quite careful in terms of how we move this forward to try to get sufficient people coming with us, because if you do announce something and no one wants to join in, it will be a missed opportunity. When you say you will track us over the next few months, you probably will not have to wait that long, because I think in terms of the work we are doing, it will either move it forward or kill it quite quickly.

Q292 Mr Binley: I was rather more gentle about my approach to you on bureaucracy than perhaps the Chairman was. That is why I asked you some closed questions, which I think you answered with alacrity. You did say that things should be set up in five months. Will you keep us informed?

Daniel Godfrey: Absolutely, yes. I think we will be back to you pretty well before then, because we will either be moving forwards with real intent or we will be saying our efforts have failed.

Mr Binley: We look forward to your regular updates.

Q293 Chair: One thing you did not answer was my question on whether the Government asked you to take this forward.

Daniel Godfrey: No. Well, the Government has encouraged us and others to try to produce a substantive and principled response to Professor Kay's recommendations. I do not think ours is necessarily the only game in town, but they are certainly supportive of what we are trying to do.

Q294 Julie Elliott: Matthew, from a British industry perspective, how will the investors' forum improve relationships between the players that are in the market? Do you think it will?

Matthew Fell: The notion of better engagement, better depth of understanding and better research on companies should over time lead to increased scrutiny and performance. Therefore, if you are able to both increase the breadth and depth of that research and understanding around companies, which the investors' forum seeks to do, that is a good thing. There are two challenges in it that will need to be overcome. The first is particularly on the investor side, if you like. How are you going to have a forum that is broadly sort of working in the same direction and striving for consensus on the one hand while all investors are trying to do the sort of value picking that we have heard about previously? How do you retain that degree of competitive edge within an environment of collaboration and consensus? That is a challenge to meet on the owner-investor side.

From the companies' perspective as well, the companies that are really up for good and proper engagement with shareholders will tell you they would like some of the different lines of questioning and some of the challenge that comes from different areas of their shareholder base. They would feel it a retrograde step if that was diluted and it was all condensed into just one view and one approach from the forum. Maintaining a sort of diversity of challenge on both sides is really important, but the overall notion of the forum is a good thing if it can add to a depth of understanding in research.

Q295 Julie Elliott: Thank you. To everyone here, who do you think are the essential people that need to be involved in this to make it work? Are they engaging with you?

Daniel Godfrey: The essential people are the investors themselves. To me, that would be the people making the buy/sell decisions within companies, but different investment managers are structured in different ways. So in some companies it will be the governance and engagement specialists as opposed to the actual heads of equities or chief investment officers or portfolio managers. Are they engaged? Yes, absolutely; they are engaged but, as I said, there is a broad range of opinion.

Penny Shepherd: The thing I would add is we see three particular groups within the investment industry practicing engagement. It is important that there is access to the investors' forum for all of them. Those three groups are, first of all, active managers of equities. As you say, they may be structured in different ways, but essentially they are people who make buy and sell decisions.

The second group are engagement specialists who are engaging on behalf of passively tracked funds, so on behalf of index-tracked funds. That is an important group as well. The third group are where asset owners have commissioned independent service providers to engage with companies on their behalf. So people like Hermes, for example; NEST uses The Co-operative Asset Management for that service; and so on. Similarly, it is also important that that group is involved.

Daniel Godfrey: I would agree with that, and if the forum is going to work, it needs to be as open to as many people as possible, because the broader it is, the stronger its voice.

Q296 Mr Binley: Kay recommended that companies should consult their major long-term investors over major board appointments. How I wish we had that ability in the House of Commons when it comes to the Cabinet, but sadly we do not. Why should companies consult with fund managers if fund managers do not consult with their clients?

Daniel Godfrey: There is an issue of delegation: firstly, fund managers will consult with their clients if their clients want it; secondly, fund managers, I think we have agreed already, could do more to engage in two-way conversation with their clients, whether they are large pension funds or small individual investors. But they have essentially been delegated to make these decisions.

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Board decisions can be quite significant. I would not disagree that companies should consult with long-term investors over board appointments, but I think it is “consult”; I think that ultimately boards make decisions and shareholders have the opportunity to express their concern or disagreement with boards. Ultimately, in the UK shareholders have a huge suite of tools at their disposal to make boards do what they want, or ultimately replace them if necessary.

Q297 Mr Binley: I dare not mention the name Fred the Shred, do I? We

might have had more input there, but that is another matter.

Daniel Godfrey: I think we have all learnt some lessons.

Mr Binley: I will not ask you to answer that one.

Matthew Fell: I was going to put an answer to your question in the context of clarity of the roles of the individual players in this. Absolutely, the shareholder’s job is to decide whether they buy into the company’s strategy and then to hold boards to account in discharging that. The board is there to set that strategy, and then to oversee it and delegate to the management the day-to-day running of the company. Shareholders will want to know and rigorously test the capability of boards to carry out and discharge that strategy, and that is why I think it is a good idea that there is that sort of engagement on key appointments.

Q298 Mr Binley: Let me just pursue Fred the Shred and the need for a sensible approach to the purchase of the Dutch bank. Would you have wanted more involvement in that respect? It has done the financial services sector immense harm.

Matthew Fell: From what I have heard on the investor side, there were attempts at engagement, and the view would probably be that there was not sufficient information and powers to genuinely hold the board to account in that scenario.

Mr Binley: That is fair.

Daniel Godfrey: I think investors would acknowledge that it was not their greatest moment. Having tried to convince the company that this was not a great deal, so many of them then voted in favour of the deal, and I think they would look back on this as something they need to learn from.

We can understand perhaps what was going through their heads at the time: “If we vote against this, it is going to destabilise the company and may impact on the short-term performance of the shares.” The lesson learned there is that we need greater ability to follow through, so there was a problem, I think, in that you would express your concerns to the company, and if effectively they put their hands over their ears, the shareholders sometimes had a tendency to say, “Well, we have done what we could, and now we get on with it.”

Q299 Mr Binley: With respect, isn’t it a question of greater scrutiny and wasn’t that lacking? I mean there is the very fact that he did not do due diligence to start with. Any company buying a company worth £100,000 would do a degree of due diligence. Isn’t

this a question of scrutiny and isn’t that a factor that your forum needs to take into account?

Daniel Godfrey: This is an area where a forum could play a very significant role in ensuring that there is follow through, rather than momentum dissipating in the teeth of opposition. Yes, I would agree.

Guy Sears: I do not want to take anything away from what Daniel says. Clearly, there were responsibilities on our side, but also in this particular case, as with others where great damage can be done, these are regulated entities. There is also a different approach now by our financial services regulator that also is beneficial in terms of judgment on judgment. That is not to take anything away; I am just talking about the context of dealing with regulated entities.

Q300 Mr Binley: The words “light touch” come to mind.

Guy Sears: I do not think we are living in that environment now.

Q301 Mr Binley: Can I move on? That was a bit naughty. Professor Kay made a clear recommendation that quarterly reporting obligations should be removed from companies, something that I agree with. It is part of the over-regulation of processes. But I am really concerned about the quality of company reports, as many of them hide much more than they ever tell you. Do you feel that there is also a role there for further scrutiny? It seems to me that company reports are often meant to obscure rather than illuminate.

Daniel Godfrey: Without going into motivation, obviously, they could be. There is a real problem with company reports. The introduction of International Accounting Standards has unfortunately made things worse. Accounts should be there to provide information to owners—to users of the accounts. The last place you would go if you wanted to find out about the company now, almost, is the report and accounts.

Mr Binley: That is the problem.

Daniel Godfrey: So, yes, there is certainly scope for further scrutiny, and I am glad to see the FRC is now acknowledging that the introduction of International Accounting Standards has not perhaps improved the clarity with which people can understand the report and accounts, and that is greatly to be regretted.

Q302 Mr Binley: I understand that, but they also need scrutiny. I do not want to create a great big bureaucracy in the forum, but I do want to see some incisive thinking that really impacts on your clients.

Daniel Godfrey: We take corporate reporting and the quality of corporate reporting very seriously. We are very engaged in that. Whether it could become an adjunct of the forum or not, I do not have a view on at this stage. It certainly is an issue that investors need to be very engaged with, because it is clearly a huge amount of wasted time, effort and money to produce accounts that are of very little value, and it also provides disadvantage to investors who are not able to do work around the report and accounts to get a real understanding of companies.

Guy Sears: I do not think regulation would be the answer, and that is why the fora will hopefully be the

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answer. This will not be the only place in which we have documents that are legally comprehensive but utterly incomprehensible. That is a problem we get very often from regulation.

Q303 Mr Binley: So it is on your little list?

Daniel Godfrey: It certainly is.

Penny Shepherd: The area specifically of non-financial reporting—of environmental and social governance reporting—is an area on which investment managers have engaged with companies to improve performance over the last few years. But it is also an area where investors have worked with companies to set standards, so that you can have more comparable reporting. Ultimately it is not just about understanding the company; it is also about being able to compare it with its benchmarks.

Q304 Mr Binley: I understand that, so can I put words into your mouth? It would be better to have a sensible six-monthly reporting process, rather than a totally unreadable quarterly process.

Penny Shepherd: It is fair to say that quarterly reporting is on its way out. It has been recognised as a blind alley. If you look back at when the European Commission introduced quarterly reporting, it is interesting to see the positive effects it was expected to have. The fear is that, when the legal requirement for quarterly reporting is removed, companies will continue to do it if they get pressure from short-term investors to do so.

That is an area where long-term investors can play a positive role in saying, “No, we are not interested in the quarterly figures; we do not want you to focus on those. What we are interested in is the long-term story and, yes, key metrics but also forward-looking reporting around what you see as the key opportunities and threats for your business, and what you are going to do about that, so we can assess the quality of you as management and we can assess the likelihood that your strategy will succeed.”

Matthew Fell: We agree that quarterly reporting does not add value and it should go. In terms of your question around annual reports obscuring the real story, I do not think there is a motive for companies to do that.

Mr Binley: I think sometimes there is.

Matthew Fell: I would disagree for annual reports, almost for the very reason that Daniel alluded to—that annual reports do not do anything to move markets at all now. It is not the place you go to really get into the report.

Q305 Mr Binley: Your comment is that you do not think they are sometimes written to obscure. I do not believe that to be true.

Matthew Fell: The major motivator there is a big sense of frustration. The sheer volume of stuff that is required to go in there turns them into doorstopper reports and makes it hard to find the data.

Mr Binley: You have a higher regard for some of your members than I do. Let us continue.

Matthew Fell: The third thing I would like to say on the narrative reporting is that a shift in that direction

would be a really good thing for driving better engaged and better quality investment decisions.

The one thing I would say on Penny’s remarks about the benchmarks and so on is it is very important that, if we do have this move towards narrative reporting, which would be a good thing, we make sure we do not get into a situation where companies have to report against particular benchmarks. The really important thing about narrative reporting is that companies are able to properly set out their strategy and investors can decide on that, and the different sort of emphasis that you will put in different narrative reporting could vary dependent on the nature of the company and the sector that you operate within.

Penny Shepherd: Briefly, I would add two issues. One is forward-looking narrative reporting. The other one is around key sector-specific metrics to assess companies, for example the health and safety metrics in the extractive industries. That is what I am talking about there when I talk about numbers.

Matthew Fell: You would put a bigger emphasis on companies in that environment.

Chair: You are in danger of having a discussion among yourselves.

Mr Binley: Thank you Chairman. I am just relieved that Daniel has got it on his little list, so we will see how that progresses.

Q306 Rebecca Harris: Penny, you commented that the way forward for Kay involves a lot more cross-departmental work on stewardship. What is your sense of the real level of appetite for change in Government?

Penny Shepherd: What I noticed with many Government consultations is that arguably there tends to be a focus on those organisations associated with the Government Department that has commissioned the review. So to give you one example, if we look back to the Walker Review that was commissioned by the Treasury and by the Financial Services Authority, which looked at the governance of banks and other financial institutions, what was quite noticeable was, yes, it commented on the governance of banks, but it did not talk about the governance of pension funds. Improved governance of pension funds is a significant driver of better capital markets. That is just one example.

If we look at the departments involved in this area, we have the FCA, the Financial Reporting Council, and The Pensions Regulator. We have DWP overseeing pension funds, the Cabinet Office overseeing charitable investment, and Communities and Local Government overseeing the Local Government Pension Scheme. This does not look like the most effective structure for getting things done. It would be very helpful if you were to look either at more co-ordination, at the future direction of relationships between regulators, or even at issues like centres of competence in Government to look at some of these issues, rather than having them spread so widely.

Q307 Rebecca Harris: The Government is proposing to publish a progress report in the summer of 2014, so less than 18 months away. What would

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you see as the absolute minimum that needs to have happened by then in terms of the Kay Review?

Daniel Godfrey: The industry needs, in whatever way, to step forward in a very substantive and principled way to advance the cause of long-termism. A part of that could be the investors' forum. A part of it could be the way in which investors engage on an individual basis. The point was made earlier by Matthew around the quarterly reporting, and in a sense that falls away as being an issue if investors are truly able to give boards the confidence that they are looking at them and measuring them on a long-term view.

We cannot ignore, and it would not be appropriate necessarily to demonise, different forms of investment management. But I think as a society and as a Government, what you want to encourage—because it is good for the economy and good, therefore, for the welfare of the citizens of this country—is a long-term approach and long-term investment. That is why this sort of hearing is very valuable, and so we need to step forward and give boards the confidence that they do not have to think over three-month timeframes and can take long-term decisions. This will drive the economic growth that you are looking for.

Guy Sears: I would only add that they are just layers and layers. Of course there are these high points, and then you have to ask whether they are individual barriers, and there are issues around conflicts of interest and the incentives that arise in our industry. I think Aviva mentioned the role of investment consultants in reviewing and determining these things over a short-term period.

In terms of the measure of success, I suppose we had hoped that, in terms of regulation and the duties expected, that would be coherent across that chain. So even if people think the chain is too long, it would at least be coherent. At the moment, different parts of it are either regulated or unregulated—different parts have different duties imposed on them.

Penny Shepherd: Looking at the demand side in summer 2014, what we have at the moment is some asset owners, like pension funds and insurance companies, supportive of the Stewardship Code and getting to grips with how they hold their investment managers to account. I certainly hope we see considerable progress in the thinking and development of that work.

More generally, I hope we see considerably more asset owners signed up to the Stewardship Code. It strikes me that there are particularly three groups that one would hope we would see considerably more progress on. First of all, we would hope to see pretty well every Local Government pension fund signed up to it. Secondly, we would hope to see considerably more corporate pension funds signed up to it, because one group that is notably absent in this area are the pension funds that are influenced by large companies. We are starting at last to see some movement on that, but there is still a considerable way to go. I would certainly hope the CBI would encourage their members to influence corporate pension funds, DB and DC, to have considerably more signatories to the Stewardship Code, and then effective implementation of that by summer 2014.

Finally, it would be so nice if by then the Parliamentary Contributory Pension Fund had signed up as well because, as of this moment, my understanding is they have not.

Chair: Thank you; that is very illuminating.

Q308 Katy Clark: Penny, you wrote that there is a clear role for Government to play in acting in a co-ordinated fashion to reform equity markets. Where do you think we are on that at the moment?

Penny Shepherd: One of the challenges of the Kay Review is that it has been commissioned by BIS, and ultimately the Government department with the greatest influence over equity markets is the Treasury through the FCA, and so ultimately one measure of success in that area is when we see the same level of commitment to long-term investment by the Treasury and its Ministers as we are currently seeing from BIS.

Q309 Katy Clark: In 2001, Lord Myners said that "it is important at least to attempt to seek an effective approach which does not rely on direct Government intervention in banning or directly determining behaviour". Ten years later, Professor Kay continues with that theme. Isn't it now time to formally regulate the market and, if so, which areas do you think more naturally lend themselves to formal regulation and which are better suited to voluntary compliance?

Guy Sears: The equity markets, just so we are clear, are subject to a massive amount of European-derived legislation through the dreaded MiFID, which is being revised at the moment. One of the difficulties with the regulation is it is designed around secondary market trading.

The real demand, I would suggest, in the thing we have been discussing is about primary markets—about raising capital. So we have driven ourselves through legislation and through incentives into a world in which the primacy of activity is secondary market trading. Kay and others have asked the question: where are the primary markets and where are those activities? That is a huge challenge on a pan-European basis, and it is a huge challenge that is going to be very difficult to address, because at the moment our whole focus really is on secondary market structures, things like high-frequency trading and the roles of alternative trading venues that London has and maybe continental Europe does not. From that point of view, that is very difficult.

If you then say the balance is between regulation and non-regulation, if I may be simple about it, good regulation ought to allow firms and participants to distinguish themselves—to show themselves as offering different service offerings from others but also to rise up in terms of standards. Getting that balance between prescribing, such that there is no difference in behaviour across the whole market because it is so prescribed, and opening up the market, so that you can compete more and show different offerings, is a very difficult balance.

To have that balance, we need to be trusted to ask for less regulation. We need to be trusted, and there is a trust issue with financial services generally. We need to move forward on that in terms of building

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confidence for us to then be able to turn round and say, “We do not need to be regulated so much.”

Q310 Katy Clark: The point I was making is it is 10 years on—in fact, it is more than 10 years on. How much longer should you be allowed?

Daniel Godfrey: If you are talking about how we create more frequent and higher quality stewardship and engagement, almost any regulation you try to bring in will not have the impact you want it to have, because it is a very touchy-feely part of business: how you engage, what you derive from it, what actions you take as a result, and what happens to the companies as a result. We can put in place things that make it look like things are happening really easily through regulation, but real progress will come from belief—people believing it will work—and also pressure from the demand side because they believe it will work, and that is entirely achievable over a period of time. You have to start somewhere.

What you will get, and what you have already seen happening just in response to the pressure from Government, is the establishment of an industry around governance, some of which works very well but a lot of which is around box ticking and boiler plating, which frustrates the heck out of the CBI members, because they get guys coming to them with clipboards, and creates a fiefdom within asset management companies. Although some of it is done exceptionally well, some of it is really cost and time wasting, and does not produce the results you want. I can almost guarantee that, if you try to regulate this, you will just get more of that.

Penny Shepherd: One of the things that John Kay calls for are effective incentives that encourage the

investment chain to do the right thing. What we think he is rightly very concerned about is rules that seek to force compliance when actually the interests of the members of the investment chain run counter to complying. That creates a market in pretending to do things and not getting caught. In a way the danger has been over the last few years that the incentives have been to not get caught, rather than actually to do the right thing.

Creating a market in doing the right thing comes down to two particular things. One is the quality of demand and addressing the quality of demand, and the other one is ensuring effective innovation and effective competition in the market. One of the worst things that could happen is the creation of a barrier around the market, so that only the current players can afford to play and new people find it difficult to come in and challenge them because of the way the regulation of the market has been set up.

Matthew Fell: I agree with much of that. On the balance between regulation and advocacy, if the task in hand is really to drive up high-quality engagement, I struggle to see how you actually generate those sorts of conversations through regulation, for all the reasons that Daniel outlined.

Chair: That concludes our questions. Thank you very much. I repeat what I said to the previous panel: if we feel on looking at the transcript that there are further questions we would like to ask you, we will write to you and would be grateful for a reply. Similarly, if you feel there are questions we should have asked you but did not, feel free to give your response in absentia. Thank you very much.

Tuesday 26 March 2013

Members present:

Mr Adrian Bailey (Chair)

Mr Brian Binley
Paul Blomfield
Mike Crockart
Julie Elliott

Ann McKechin
Mr Robin Walker
Nadhim Zahawi

Examination of Witness

Witness: **Rt Hon Vince Cable MP**, Secretary of State for Business, Innovation and Skills, gave evidence.

Q311 Chair: We are very slightly early, but I think we can get going. I realise that time is pressing for you, Minister, as well as ourselves. Can I thank you for agreeing to speak to the Committee on the Kay Review and welcome you? Just for voice transcription purposes, could you introduce yourself?

Vince Cable: I am Vince Cable, Secretary of State for Business, Innovation and Skills.

Q312 Chair: Thanks very much.

I want to start with a fairly general question. You may remember these words: “And the principles of responsible ownership should apply across the business world...So I am shining a harsh light into the murky world of corporate behaviour. Why should good companies be destroyed by short-term investors looking for a speculative killing, while their accomplices in the City make fat fees? Why do directors sometimes forget their wider duties when a cheque is waved before them? Capitalism takes no prisoners and kills competition where it can.” That, of course, was your speech to the Lib Dem conference in September 2010. You set up the Kay Review as a result, in part, of that speech. Now I have the Government response to the Kay Review, and their responses will be: “working with the EU counterparts to end mandatory quarterly reporting”; “endorsing clear minimum standards of behaviour for all investment intermediaries”; “the Law Commission has been asked to review the legal obligation on intermediaries”; “encouraging industry to establish an Investors’ Forum”; and “endorsing Good Practice Statements for company directors.” We had the sound and fury of your speech and then the somewhat less robust response from the Government. Just how many prisoners of capitalism do you think will be released as a result of this?

Vince Cable: Probably quite a lot over a long period of time. As you know, a party conference does induce poetry that we perhaps lack in our everyday discourse, but I do not, in any sense, retract the principles that I was talking about. We wanted to be guided by evidence and therefore we asked a distinguished academic and journalist to lead this review—he was backed by an industrialist, Sir John Rose, among others—and he has produced a report that relies very heavily on cultural change, rather than regulation. This is done, essentially, by trying to ensure that the whole complex chain of equity financing becomes much more transparent and operates on the basis of trust, which had largely broken down.

If I can add to your general question at the beginning about what we are doing, of course it is not just the Kay Review. In addition to the Kay Review, we now have an industrial strategy evolving, which depends very much on accepting the long-term nature of investment in many of our key industries and the need to work on a partnership basis with them. We have changed the terms of reference of the competition authority, so it must have regard to long-term investment decisions. The system of executive pay has been radically overhauled through Parliament and, again, that gives a longer-term dimension to decision making. Also, the takeover panel has reformed its activities, encouraged by us, not in dramatic ways, but in ways that will significantly address the issues I raised in the speech.

Q313 Chair: I think it is probably fair to say that the reaction to Kay was that it was very good on analysis, but weak on recommendations. I can see the problem from a ministerial perspective that it is very difficult to have bite on such a weak set of recommendations. Could you just say what the factors were that made you want to look into Kay, in particular, stripping out the conference rhetoric there? How far do you really think they will be addressed by the measures being taken by Government?

Vince Cable: The premise of your question is a criticism of Kay’s report, because it relies on voluntary compliance rather than regulation; I do not regard that as a criticism. These problems are complex and they do, ultimately, rely on a very complex financial system and a tier of intermediaries. There are limits to the extent to which either British or European regulation can address those failings. If they can be addressed by the industry itself, through good practice and through the investors’ forum—which is one of his key recommendations, through it is not a hard, aggressive regulation; it does rely on voluntary compliance—and if we can get that right, it will make a big difference over time.

You asked what prompted me to get into this whole field. It was the fact that when I came into this office, as you know, we had some pretty fierce controversies about takeovers and whether the time perspective was right. I was making factory visits to some of our leading engineering companies who were saying that they want to invest 10 or 20 years ahead, and they find it difficult to get the equity markets on the same wavelength; it was about how we address that problem. That is what led me into it. Although the arguments that come out of it do not involve a lot of

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mandatory regulation, it is not just analysis; these are good conclusions. What we now see happening is that the key players—such as the IMA, the investment managers, the pension funds and the insurance industry—are thinking very carefully about how to put this into practice and improve their good practice arrangements. We have had some very good statements in recent days from the Chartered Secretaries and from the NAPF—the pension funds—about how they are going to adapt their practices in the light of Kay, and that is good. We have also seen the European Union, which has major legislative responsibilities in this area, produce a green paper to guide its future work, which could have been written by Kay—it embodies all the arguments and principles.

Q314 Chair: One of Lord Myners' contributions was, in effect, to say he produced a similar report 10 years ago, and he did not feel that, shall we say, the culture had changed enormously as a result of that report. I am perhaps paraphrasing him. Do you really think, in 10 years' time, that the Kay Review will have resulted in a change of culture that will have actually delivered on the issues that you have outlined?

Vince Cable: I think so and I hope so. We are not letting the matter rest; it is not just a question of getting a report, sticking it on a shelf and vaguely hoping that people comply with it. We have made it very clear that in the summer or autumn of 2014 we want to go back over what the Kay Review has recommended to make sure that these things are actually happening. We are also commissioning a group of independent people who will track these recommendations and see that they are being followed through. You are quite right that there is always a danger of nice reports that just never happen. I did look over some of the evidence of Lord Myners. Essentially, when he came before your Committee, he started being quite critical of John Kay but, I think before the end, he effectively, while not retracting it, said, "Well, I've been actually a bit over-critical", and I think he concluded in his evidence to you that, basically, he had said the right things and come to the right conclusions.

Q315 Chair: Yes, I think he agreed that it said the right things. What he was concerned about was the political will to make recommendations arising from them.

Moving on, the equity market has seen huge technological changes in the past decade or so, and a lot of the evidence to this Committee indicates that that has actually given even more advantage to the institutional investor. Where, in the Kay Review, and the Government response to it, do you think there will be an enhanced voice of the owners of capital as opposed to the managers of it?

Vince Cable: Kay sees a chain going all the way back from the ultimate investor, through the chain, to the asset owners—the pension funds and the institutional investors—and wants to make sure that the distribution of costs is completely transparent, and that there is no abuse at various points along the chain and, therefore, there is basic trust. That set of relationships is set out very clearly. You make the point that we are dealing with important technological change. One of the things we are trying to encourage

in the Government—and, again, we have to work through European institutions and legislation—is to create a proper electronic platform, which is the way business increasingly will be transacted.

Q316 Chair: You referred to Lord Myners earlier and his evidence. One of his concerns was that arising from his experience when he did his review, he was subjected to intense lobbying from the financial services industry, and this was repeated when he was a Minister. Can you say whether you have been put under that sort of pressure?

Vince Cable: No, I have not. The financial services industry, particularly banking, has been rather humbled by the experience of the last few years and will probably be rather less aggressive now than it used to be. Far from being aggressively lobbied, I have actually sought out these groups to talk to them and get their feedback. Certainly within the last few months, I have been to talk to pension fund events and insurance industry events. I have met investment managers and tried to put to them the Kay Review arguments, in order to encourage them to set up this investors' forum, as well as talking about the more general long-termism agenda and trying to engage them in it. In answer to your question, no, I have not been subject to aggressive lobbying, and certainly nothing that I would want to complain about.

Q317 Chair: In terms of your dialogue with the industry, could you give us some idea of, over the past 12 months, how many meetings you have had with the representatives of the financial services industry and also with the representatives of "responsible" investment groups, such as ShareAction, UKSIF and FairPensions?

Vince Cable: I cannot produce an inventory, but we are talking about high single figures to perhaps a dozen—probably something of that order. Quite a few of these occurred in the context of the work that we did on executive pay, where we organised a series of workshops with key people in the industry, including the institutional investors. That was a separate exercise, but I did engage substantially with the industry on that set of issues. In parallel with that, there was some discussion on Kay follow-up.

Q318 Nadhim Zahawi: Secretary of State, just on that point, some of the response we have had from those industry practitioners is that some are taking this very seriously—we have had Fidelity, Aberdeen Asset Management, and others come before us. However, some of the feedback is that others are thinking, "This will just go away if we ignore it". What message do you have to those who just want this thing to go away?

Vince Cable: If they are going to avoid the opprobrium that has descended on the banking industry, they would be well advised to follow best practice. That is one of the lessons of recent history. There are initiatives opening up by their industry bodies—the trade bodies. Now, of course, as you quite rightly say, it is the membership that matters, not the trade bodies. The trade bodies have now set up a steering group to launch this investors' forum, which is at the heart of the Kay recommendations, and so I would strongly encourage them to participate in that and make sure it works. I would also strongly

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encourage them to listen to the statements of best practice that have emerged from the representative bodies in the industry, because that is how standards are raised.

Q319 Nadhim Zahawi: If they do not, is there a big stick that you can wield?

Vince Cable: We are not currently thinking of that and there is no obvious big stick to wave. There are certain specific problems, like remuneration, where we have introduced some sticks, and there will be European regulation under the UCITS directive and so on. That will be mandating, and our job in the UK Government is to make sure that that heads in the right direction. We are not waving big sticks and that would go contrary to the Kay philosophy, which was about building up trust.

Q320 Nadhim Zahawi: It has been pointed out to us that the Government are encouraging diversification—for example, tax breaks connected to managed ISA funds. This is an outcome that has obviously suited the fund management and banking industry very well. How do you see these incentives changing in the future?

Vince Cable: I am not sure we are talking about quite the same thing, but if we are talking about diversification—the building up of equity markets—there is a whole series of initiatives. One that you mention is using ISA products as a vehicle for, say, AIM equity. The Government, as you know, have scrapped stamp duty on AIM shares, which will help to diversify that equity market. There are discussions taking place with the Stock Exchange about how to improve entry to the higher-level FTSE, rather than the AIM market. A whole lot of initiatives are being taken to broaden out and deepen equity markets.

Q321 Nadhim Zahawi: On the Chancellor's announcement of the scrapping of stamp duty on AIM shares, how do you think that will affect your response to and the implication of the Kay Review?

Vince Cable: It is a useful step forwards. There was a very good report published recently by the think-tank Reform, which explained why that would make a key difference. We know that equity markets are defective right the way up the chain. From so-called friends, families and fools at the bottom, right up to the FTSE 100, there are gaps in the equity chain, and that will fill in one segment of the market.

Q322 Nadhim Zahawi: Similarly, for business, there appears to be a vast gap in the way different sources of finance are treated. Would you prefer companies to finance their growth through debt or equity?

Vince Cable: In general, I would share the view that the Chancellor and others have set out that our system does load incentives to debt, rather than equity, and it would be sensible and helpful over time to try to shift that. The problem is about how you do this through the tax system. You have got an enormous number of companies that are loaded up to gunnels with debt, and if you stop them withdrawing interest relief, you put them into even deeper problems, so we have got to work through the debt crisis before creating that kind of unintended consequence. However, if we can devise tax and other regulatory interventions, we certainly should be trying to make equity more attractive, relative to debt.

Q323 Nadhim Zahawi: That was going to be my follow up—interest payments on debt are obviously tax-deductible, whereas similar returns going to equity investors in the form of dividends are not.

Vince Cable: You know this area. There are considerable limits to interest offsets, but the principle is right, yes.

Q324 Nadhim Zahawi: Given your preference to move to equity finance, what representations have you made to HMRC and the Treasury on this, in relation to changes in the tax system and to rectify these perverse incentives?

Vince Cable: Not a great deal, but interventions like the AIM market and the encouragement of seeds-type activity are all part of that general approach, which we would certainly want to encourage.

Q325 Nadhim Zahawi: Can we go any further than that, or is that as far as the Business Secretary will take it?

Vince Cable: I will just mention one or two other things. We do envisage, with the business bank that is now getting off the ground—we put in a written ministerial statement last week explaining it—that quite a big component of that will actually be about equity development. It will not just be about loan finance, so that is something we did not expect when we got into it. We are now realising that that is where a lot of SMEs are trapped and we think we can do some quite creative work with the business bank on equity financing as well as loan financing.

Q326 Nadhim Zahawi: Absolutely right. Just on the Kay Review, who wrote the Government's response? Which Department and which officials wrote the response?

Vince Cable: There are officials in my corporate governance section—very good officials—who wrote it, and I, of course, looked over it before it was issued.

Q327 Nadhim Zahawi: Did any official involved in Professor Kay's team have any influence over the Government's response?

Vince Cable: Are you suggesting there is something irregular?

Nadhim Zahawi: No, it is just a question.

Vince Cable: No, there are some extremely knowledgeable officials who I respect and I listen to what they have to say. They know far more than I do about this subject.

Q328 Chair: If my memory serves me right, this arises out of something that Lord Myners said, when he effectively said it looked as if somebody on the departmental team had basically just reproduced what the Kay Review was saying and, effectively, they were marking their own homework.

Vince Cable: I met John Kay and his team several times when they were doing the report, and I did not get the sense that they were being led by the nose. John Kay is one of the brightest people around. He has written an extremely good book, which is widely used, on corporate governance, and he was very much developing his own ideas, rather than the views of my officials.

Q329 Mr Binley: You have been very kind to the members of this Committee in having met with us on this issue on two occasions so far, and we are very grateful for that, and that has been very helpful. You

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know our concerns arose out of the hostile Cadbury takeover, which we felt was a group of American pirates—if I can put it at its worst—trying to get hold of one of the jewels in the British industrial and commercial crown. I still remain of that view, actually, and I was hopeful that Kay might do something about this. Indeed, in your written evidence submitted to this Committee, you said that “the Kay Review seeks to shift the culture of UK equity markets to ensure they support long-term investment” and “constructive relationships”. The hostile takeover did not start off well, with regards to Cadbury in that respect. I wonder what you see in Kay at the moment to suggest that that situation will be improved for the future, should similar occurrences arise.

Vince Cable: It is fair to say that my interactions with your Committee started off with the takeover, did they not? As I said to you at our last meeting, the outcome has not turned out to be anything like as bad as was forecast.

Mr Binley: I think that is fair.

Vince Cable: Of course, Kraft is now doing quite a lot of global R and D work here. In terms of where it led, the first set of actions related to the takeover panel, where we did encourage the takeover panel—a self-regulating body—to toughen up its approach to takeovers. The expression used is “throwing a bit of sand in the wheel”. There are the put-up-and-shut-up requirements; the requirement that boards are no longer obliged to take the biggest offer if it would lead to a short-term benefit but long-term loss; and greater transparency over the fees of the intermediaries who are making money out of the takeover. All those things came as a direct consequence of that worry about takeovers. There has subsequently been quite a lot of stakeholder consultation around the takeover panel’s activities. The conclusion we have come to, at least for now, is that those changes have made quite a bit of difference—probably more than we had assumed at the time. If there is a new surge of takeovers which have the damaging effect that you and others fear, we can certainly go back to this. There are issues you may want me to discuss about whether we should be giving preference to long-term investors over short-term investors, and so on, which we have not yet done and are difficult. However, we can certainly go back to those if there is another outburst of unhelpful activity.

Q330 Mr Binley: Secretary of State, that is encouraging and I am most grateful to you. Can I, however, just be slightly more specific about the short-termism involved in hedge-fund funding that happened, to a sizeable extent? I think about 27% of the money in the Cadbury takeover was provided by very short-term hedge-fund thinking, and it was a hostile bid. I just wonder whether we can still go back to the possibility of a time limitation on hostile takeovers, and whether there is anything we can do about short-term money, in the light of your need to have more long-term investment.

Vince Cable: My instincts are to go back to it. As the Chairman quoted of me in my party conference speech, that is probably where my instincts are. Let me just set out the reasons why we have not done that, and they are quite compelling. You could perhaps help

me by finding a way past them. The arguments that are put are the following: first, if you stop the short-term investors, you reduce the demand for shares, you drive down the share price and you then make the takeover more attractive; secondly, you stop long-term investors from acquiring shares in order to build up their stake in the company during the takeover period; and thirdly, we do not have an effective system, at the moment, for distinguishing between nominees and original owners. In the UK, we do not have that, so it is not possible to divide the share register in the way that one would ideally like. Moreover, if you tried to, there is a danger of setting up secondary trades in ultimate ownerships—in other words, to defy the rules. Now, I see those as a challenge rather than as a fundamental objection to never doing anything, but these are quite serious problems, and if we are ever going to take that forward, we have got to find a way around those arguments.

Mr Binley: You set us a challenge and I am hopeful the Chairman might accept it.

Q331 Ann McKechin: Good morning, Secretary of State. There is a current argument that there is really no way to establish whether public companies are providing a good purpose or if the market price really reflects the true value. Which of Professor Kay’s recommendations would rebalance this perception, in your view?

Vince Cable: I am not sure if this is quite what you are driving at, but he does raise the old issue about whether mark-to-market pricing is, in fact, seriously distorting, or actually helpful—that is the issue he raises. The problem is we are operating with international and European rules on mark-to-market accounting. One way in which we have anticipated the criticism you rightly made about there often being distorted values is through the pension regulator, which now has an obligation to look at long-term growth. With defined benefit funds, they will be obliged to think beyond the immediate mark-to-market solutions, which could involve them doing very damaging things to companies. Kay does pursue that argument and suggests the way forward.

Q332 Ann McKechin: So you are hopeful that if there is a change by this major set of institutional investors, that would actually also influence the entire market, as a result.

Vince Cable: Yes, it could do.

Q333 Ann McKechin: Which of Kay’s recommendations will change the perception that institutional investors do not act as true owners of businesses? You have mentioned pension investments. There is also this issue about fiduciary duty and you have asked the Law Commission to review it. Perhaps I could just press you a little further. Do you consider that when the Law Commission does eventually report, the Government then actually have to provide the clarity and guidance to make the changes, if they are recommended, in legislation?

Vince Cable: Yes. This is actually a very important stage in the follow-up to the Kay Review, and thank you for picking it up. We set the terms of reference today, where the Law Commission is already actually looking at this, because there is ambiguity about what fiduciary duties really are in different points of the

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investment chain. The answer to your question is that yes, if it does recommend legal change—it may well do—we will go down that route, but we obviously do not want to prejudge what they conclude.

Q334 Ann McKechin: Do you have any anticipated timetable for when it is likely to report back?

Vince Cable: I asked myself and my officials that question. I did not want this to be reporting in 25 years time. The Law Commission does have a *Jarndyce v. Jarndyce* approach to legal cases. We would express the hope—and I have expressed the hope—that it will do this quickly.

Q335 Ann McKechin: By “quickly”, do you mean some time this year?

Vince Cable: I would hope that before the end of this Parliament we will have a very clear answer to the questions we pose.

Q336 Ann McKechin: Should more people in fund management have practical experience of business management? This is an issue that Lord Myners, as you may recall, raised in his evidence, and it has also been raised by others. As few hedge fund managers have practically run a business, their ability to make long-term decisions or to understand them is limited.

Vince Cable: I guess, in an ideal world, that that should happen. We could probably say that for politicians as well, but we do not have many, with one or two exceptions here. I am not sure how you would make that happen, other than to incorporate it into best practice. Given that the investment management chain is now adopting best practice codes, maybe that is a good thing that should be incorporated.

Q337 Ann McKechin: Could that be part of the stewardship code that Kay talked about? Could there be reference to people having more experience?

Vince Cable: Yes, I take your point entirely. Of course, there are big companies and small companies and they have different levels of expertise associated with them.

Q338 Chair: Just before we move on, I am not sure which representative group it was, but certainly one pointed out to the Committee that the parliamentary contributory pension fund has not signed up to the stewardship code. I recognise that is not your specific responsibility—it is, indeed, a collective one here—but I personally feel that is slightly embarrassing, as we need to be exemplars ourselves. Do you see any role for the Department in promoting that?

Vince Cable: I was once a trustee of that fund.

Chair: So you are to blame.

Vince Cable: When I first came in, so I am probably partly to blame.

Chair: I have to say I was not aware of that when I asked that question.

Vince Cable: As we know, Government and Parliament are distinct entities, and we would not want to lean on Parliament to improve its practice. However, you make a very good point and if there are any trustees here, they should take it as their responsibility.

Chair: We will be looking at a way to do so.

Q339 Mike Crockart: I would like to turn to specific recommendations. First of all, on the third recommendation, it says, “An Investors’ Forum should be established to facilitate collective

engagement by investors in UK companies”. To me, that sounds a bit like management speak, and it is unclear exactly what it is driving at and what the investors’ forum should be doing. We know that the Investment Management Association is taking that forward, but have you provided a remit for what that forum should be looking to do? Do you have views on what the features of it should be?

Vince Cable: We do not have a remit and we did not consider that our job. We considered the Department’s job to be actually trying to get the people together to make sure they did it, because we had thought that the Kay Review was sufficiently clear about what that investors’ forum would achieve, and that the bodies should themselves take the responsibility for organising it and should promote it—which they are now doing through the steering body—but, of course, they should not run it, because it should be independent of the trade bodies. It is going to be quite tricky because, on the one hand, we are getting them to talk to each other, and we are getting people to talk about the boundary between investment institutions, but we do not want collusion and we do not want insider trading, which is the worst form of conversation that could take place. The best institutions do have very clear Chinese walls to permit these conversations to happen. To answer your question, no, we do not have a departmental remit telling them what we think they should do; we think Kay gives enough guidance on that.

Q340 Mike Crockart: Do you have any knowledge of when the first investors’ forum will actually be held?

Vince Cable: I do not, but now that this steering group is established, I would hope we are talking about weeks or months, rather than years, but I cannot give you a precise answer.

Q341 Mike Crockart: The ABI, IMA and NAPF issued a press release today which, in fact, I have to say is a mastery of saying very little and using lots of words to do it. Having read it, I am unclear whether what is now being set up, which is a working group, is the investors’ forum, or whether it is a working group to look at what an investors’ forum should be doing.

Vince Cable: I think it is the latter.

Q342 Mike Crockart: Right, okay. So it is to report in the autumn with recommendations as to how collective engagement might be enhanced to make a positive difference. It feels quite amorphous and it is difficult to see what progress is being made in any real time.

Vince Cable: That is, maybe, a fair criticism. I would take it as a criticism of them.

Mike Crockart: Absolutely, but I am raising it with you.

Vince Cable: If the forum has not happened in the autumn, when this steering group reports, I think you would have good grounds for coming to me and saying, “Why aren’t you chivvying these people along? The report’s been out there for a year or so. Why is nothing happening?” That would be perfectly legitimate.

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Q343 Mike Crockart: Do you have views about the specific resources that an investors' forum would require, in terms of funding, particularly?

Vince Cable: We have envisaged that this is something the industry should be doing in its own interests and it should fund it. There has been an issue about levies. The real resource that would be required is serious research, particularly if you are developing metrics and things of that kind. We are organising, at the moment, a competition to establish better metrics for investment managers in the investment chain, but it would be the industry's job to put this on a permanent footing, and it would have to fund it. There is an issue about how they charge their members for it and how transparent that charge is. The simple answer is that we do not see this as the Government's job. It is the industry's job; its own reputation is at stake.

Q344 Mike Crockart: But a watching brief would be kept. Turning to another specific recommendation—we have touched on it a little bit—which is that the Law Commission should be asked to review the legal concept of fiduciary duty. Can I start by asking what you understand by the term “fiduciary duty”?

Vince Cable: It is the duty in law of the people in the investment chain towards their clients. I think that is what we are talking about.

Q345 Mike Crockart: Given the fact that most of our witnesses seem to have a clear view, much the same as yourself, of what fiduciary duty is, why do you think that the Law Commission needs to have a look at redefinition? How do you think that will actually help compliance?

Vince Cable: This goes right to the very beginning and how far they have an obligation to think about long-term value, rather than short-term returns. What does the existing system of investors' responsibilities tell us? Again, I am not a lawyer and I am certainly not a lawyer in this rather recondite field, but I am told that the law is a bit ambiguous and it needs clarification as to where first duties are when there is a conflict of objectives.

Q346 Mike Crockart: Although most of our witnesses seemed to be fairly clear about what it meant, one witness did say that they thought the law prohibits good behaviour, or that there was certainly a perception that law prohibited good behaviour.

Vince Cable: That is exactly the kind of thing that we need to get to the bottom of. When people are saying things like that, which sound a bit strange but are maybe true, we need to get the top lawyers in the country coming to a definitive ruling.

Q347 Mike Crockart: My final question was going to be: what should we expect after the Law Commission has reported? However, I think you have already answered that in saying that you are minded to take forward any recommendations that it comes up with.

Vince Cable: Yes, I would sincerely hope so. It probably requires legislation, but that is obviously a matter for the House.

Q348 Chair: In terms of both the investors' forum and the Law Commission review of fiduciary duty, it would appear that a process is being set up that could significantly delay any action on these issues.

Certainly, in terms of the latter, I have had it to put to me that giving it to the Law Commission is just a way of kicking the issue into the long grass. Have you set a deadline for either—or both—the investors' forum to be set up or a conclusion on the issue of fiduciary duty from the Law Commission?

Vince Cable: We have not set a deadline, but I have specifically asked that they deal with this expeditiously and get a move on, precisely because of the suspicion that I had already heard, which you have expressed very well. We do want some answers quickly. The problem about taking shortcuts on complex, legal questions is that the outcome is then disputed. The whole purpose of going to the Law Commission is that what emerges then becomes a definitive interpretation that we can act on. It is frustrating and, like you, I would much rather we had some quick results with some of these things.

I think there is a prevailing cynicism—sorry, in fact I have actually got something more concrete. The Law Commission will consult this year and report no later than June 2014, so there is a deadline. I am sorry; I misled you.

Chair: Yes. I was going to say I am not sure whether that reinforces your argument or the argument of representatives of the Committee. It does demonstrate that the Law Commission's interpretation of a speedy review is rather different from that of most people in the universe.

Q349 Mr Binley: I note in the Government's written submission to this particular inquiry that you are promoting the revised edition of the stewardship code, which was published in September 2012, which emphasises that stewardship should encompass engagement via investors in company strategy. You will know, Secretary of State, that I, and I think other members of this Committee, are not overly enamoured with voluntary codes, and I would only point you to the pub code in that respect, where prevarication has been the name of the game, almost from the outset. Are you concerned about whether the code is fit for purpose now—and clearly you are not, because you are waiting for what the Law Commission says—and what powers do you have in your own hands to make sure that it is an Act that is brought into effect in good time, and it does not linger on as the pub code has almost ad nauseam, quite frankly?

Vince Cable: The way we are dealing with companies is a mixture of voluntary stewardship codes of practice, on the one hand, and legislation on the other—there is a two-track approach to most of these questions. In the mandatory area, of course, we have the legislation on executive pay, and narrative reporting is coming into effect as well. On the stewardship code itself, we have just had a wholesale revision, which the FRC oversaw—you know the way the system works. Next year, we have asked them to go back to the stewardship code specifically to take into account the Kay recommendations. It is a twin-track approach. There are key areas of corporate behaviour that have to be regulated, and are regulated, but for other areas, where subtle changes are involved, the voluntary approach works well, as it is the best solution and it works.

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Q350 Mr Binley: I accept the last phrase. I wonder if you can give us a little more confidence by telling us the evidence you have to the effect that the voluntary code will work in this respect, because we are perhaps talking about a pretty heavy area of activity dealing with other people's money. One might think that that gives it an extra impetus for action.

Vince Cable: Maybe I should just give you one example of where voluntary behaviour is moving in the right direction, but where you have the ultimate sanction. Maybe I could give you two examples where you have the sanction, ultimately, of a regulatory solution. One of them is the disclosure of votes in companies, where we have progressively had an increase of disclosure—on one measure it is 75%; the TUC has a slightly lower measure. There is clearly a tendency towards disclosure by institutional investors on how they voted on issues like executive pay, so the trend is in the right direction. They know, and we have said, "If you don't do it, we will ultimately legislate," but voluntary behaviour has worked. The other slightly different area is female representation on boards, where we are adopting a stewardship-code approach. We have set objectives and asked them to do it themselves in their own way, and there has been a significant change over a two-year period.

Chair: We are looking at that issue in a separate inquiry.

Vince Cable: Yes, I did not want to get into the issue. I was just using these examples for Mr Binley about how a voluntary approach can achieve results.

Q351 Mr Binley: Can I ask you about time frames? You have responded, pleasingly, very quickly with regards to the prevarication with the pub code, and we welcome that enormously. I wonder what time frame you are thinking about giving a voluntary code being set up in this respect before you do move to your heavier shot across the bows.

Vince Cable: It obviously depends on the feedback. We knew there was a problem with the pubs because of the howls of pain from a lot of publicans. If we get a very strong sense from companies that, despite all this nice talk, nothing much is changing and they are being short-changed by the equity investor community, we can do stronger things. It depends on the feedback, obviously.

Q352 Mr Binley: So the Law Commission data are pretty important in terms of your judgment in this respect.

Vince Cable: On the fiduciary duty issue, yes.

Q353 Mr Binley: Also, can we link the same sort of time frame to the code?

Vince Cable: Yes, the stewardship code is being revisited next year anyway.

Mr Binley: That is what I thought.

Vince Cable: By the FRC. It has already committed itself to doing that.

Q354 Chair: Before we leave this issue, I do recall us having a disagreement on this at a previous session when you were talking about salaries. There does seem to be conflicting evidence on the level of, shall we say, transparency and adherence to the stewardship code, and you yourself pointed to different evidence from different bodies. My understanding is that, first of all, not enough companies sign up to the

stewardship code. Secondly, there are those that do adopt a tick-box approach, which does really reveal the full extent of their involvement or lack of involvement. What evidence will you use as an evidence base for determining whether you need to go in harder on this?

Vince Cable: I would turn it back to you, in a way. I have not heard the stewardship code being discussed in quite such negative terms, but if your Committee—

Chair: I do not think it is the stewardship code that is; it is the adherence to it and transparency.

Vince Cable: If your hearings—and this is what you are doing—do elicit quite a lot of evidence that this approach is failing, I would feel obliged to respond to it, as I did when you similarly did valuable work on the pubs.

Chair: That is a very welcome comment, Minister. We may well look at that. Thank you.

Q355 Mr Binley: I think I know the answer, but do institutional investors dedicate enough resources to corporate governance and stewardship, in your opinion?

Vince Cable: I would like to see more, but I cannot give a very informed response.

Q356 Mr Binley: It does lie at the heart of what you are trying to do, does it not? I wondered whether you have got any evidence, because Aviva Investors is suggesting a simple way of resourcing stewardship: use equity commission towards what it calls a long-term investment on research, voting advice and stewardship work. Is that how you thought this thing should proceed?

Vince Cable: I said, in response to Mike Crookart's question, that clearly there does need to be proper research and they do need to have good metrics that are trusted and credible. That does involve a certain amount of investment and the obvious way for the industry to invest would be to make a contribution from its own coffers, and those would then have to be transparent so that investors are aware of them.

Q357 Mr Binley: Again, time frame is important. I wonder how quickly you then feel that could be implemented.

Vince Cable: Again, it would be a bit invidious if I just plucked a date out of the calendar. We are hoping that by the summer of 2014, when the Government conducts its own review of the effectiveness of the Kay Review, of which this is one, we will then be able to see tangible progress. That is the kind of timeline we are working to.

Mr Binley: So, we revisit this in a year's time or thereabouts.

Vince Cable: In about 15 to 18 months.

Q358 Paul Blomfield: Secretary of State, I wonder if I can move to a different issue: the financial transaction tax. We have heard from a number of the witnesses, including Professor Kay and Lord Myners, that there is a positive case for an FTT. Putting aside the specifics of proposals that might be on the table at the moment in Europe, on which you have expressed your views, and also putting aside the revenue issues, do you think that there is a case for a financial transaction tax to discourage short-termism?

Vince Cable: Yes, I think there is a case, and I am, in some ways, quite disposed to it. I originally worked

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on Tobin tax concepts 20 or 30 years ago, long before I came into this place. The problem, all along, has been implementing it in a way where you have very rapid electronic transactions where cross-border transactions are very difficult to trace. I saw some of the figures this morning coming out of the European Union on its first experience of this. Countries like Hungary, France and elsewhere were getting in a fifth or a quarter of the revenue that they thought they would get, because it is so very, very difficult to pin down these transactions and tax them in a sensible way. I have no objection to—well, I would put it more positively: I think there is a case, if you are trying to change behaviour, for using a market instrument of that kind to make that happen.

Q359 Paul Blomfield: Is the rapid nature of the electronic transactions not part of the case for the tax?

Vince Cable: It could well be. The problem that Tobin was originally trying to address was transactions in foreign exchange markets. We have now moved on to a different world where that is no longer an issue, but you could argue that for very rapid transactions, which yield very little value—I think Lord Turner came before your Committee and may have made that case a couple of years ago—there would be an argument for using tax in that way. The reason why the British Government have been pretty negative about it is mainly on grounds of practicality. The other reason we have been sceptical about it is, of course, most of the revenue would be generated in the UK and, under the European Union's proposal, would be repatriated to Brussels which, understandably, we are not too happy about.

Q360 Paul Blomfield: Putting aside the specifics, given there is general warmth to the idea, we have also heard that it was an area in which the review feared to tread. Are you concerned that the review that you commissioned felt that it was unable to recommend freely in this area?

Vince Cable: In relation to that tax?

Paul Blomfield: Yes.

Vince Cable: They certainly were not forbidden from doing it, or discouraged from doing it. John Kay is a very good economist and has written extensively about it, and he probably realised that the analysis had been pushed about as far as it could usefully go. I suspect that that was why it did not feature more prominently.

Q361 Paul Blomfield: Did you have a specific conversation with him at any time about it?

Vince Cable: I seem to remember it was on the agenda when we had our report-back sessions, and we did exchange views about whether the tax system could be used to change behaviour. The transaction tax is one, but there have also been arguments, as you know, about capital gains tax, which operated under a different regime when your party was in government. That is another way of using the tax system. There was some discussion of that, but I think he felt it was not very productive.

Q362 Paul Blomfield: On a related issue, the Chancellor, when he was making his Budget statement in relation to stamp duty, said that in parts of Europe they are introducing a financial transaction tax, but

here in Britain we are getting rid of one. Did he consult you about his decision on stamp duty?

Vince Cable: That combination of things was not put together. They are very different.

Paul Blomfield: It was interesting that he linked them in that way.

Vince Cable: We are actually increasing stamp duty in the UK on high-value properties, as you know, so there are certain kinds of big, lumpy transactions where we are using stamp duty to deal with, frankly, rampant tax avoidance that is happening at the upper end of the property market. We are therefore using stamp duty in certain cases. The reason why it has been waived in respect of AIM is to achieve a particular set of policy objectives, which is to reduce the costs of medium-sized companies coming to the market. There is an enormous difference between the way the stamp duty would operate on an AIM equity deal, which is one big payment for one lumpy deal, as opposed to trying to tax a thousand electronic transactions in a minute or however the system works.

Q363 Paul Blomfield: Perhaps I could move on to a different area: mergers and acquisitions. I know a number of colleagues will also want to come in on this one too. Perhaps to start off, how do you see the nature of mergers and acquisitions in a post-Kay world?

Vince Cable: At the moment it is fairly dormant; there is not a great deal of activity taking place. There are large cash piles around that you would have thought, in normal circumstances, companies might use for aggressive acquisitions. My general view about this, which I have expressed to your Committee before, is to be a bit sceptical of the value of takeover activity. There is a lot of research that tends to show that, probably on balance, it reduces shareholder value, quite apart from any social consequences. However, there is counter-evidence. There was a big report by the Cass business school a year ago, which tended to show the opposite. I am sceptical about the value of takeover activity, but recognise that in a capitalist system, you do need to have it, because if companies are underperforming and their shareholders are being poorly awarded for bad performance, there has to be a mechanism in the market to correct that.

Q364 Paul Blomfield: Do you think that things will change specifically as a result of Kay's recommendations, if implemented?

Vince Cable: Not a great deal. If we are looking for change, we would have to look to the takeover panel and the existing rules, and whether they need to be developed further, and indeed the more radical solutions, which have often been put about public interest tests, which we have not followed through. However, if one was really concerned about damage in this area, that would be the way to do it. There is nothing in the Kay Review that will radically change the mergers-and-takeover landscape.

Q365 Paul Blomfield: Can I ask you specifically about shareholder rights? Very specifically, at the time of takeover, do you think that short-term shareholders should continue to have the same voting rights as those with a long-term interest in companies?

Vince Cable: I gave quite a long answer to the Chair or Mr Binley about that before. We have certainly

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looked very carefully at this because of the reasonably well-grounded fear that hedge funds and other short-term investors can drive the wrong kind of merger. We looked at that very carefully but, as I said, attempts to restrict it by making an arbitrary distinction—say between a six-month investor and a six-month-plus, or a year and a year-plus—would probably have all kinds of unintended consequences and would be very difficult to pin down because of the issue of nominee shareholders. I agree with you that it is a serious question, and I frequently engage serious people who try to make that case, and I have quite a lot of sympathy for them.

Q366 Chair: I believe I am right in saying that one of our previous witnesses claimed that there had been no benefit from any hostile takeover in the UK over the last few years. Is there any authoritative research that the Government have done to assess whether this assertion is correct or not?

Vince Cable: I think I am correct in saying that the Cass business study was actually prompted by our Department, but I cannot remember whether we funded it or not, but we certainly encouraged it. It did not actually reinforce that conclusion—I might say “unfortunately”, but it did not.

Q367 Paul Blomfield: Specifically on section 172 of the Companies Act, do you think shareholders’ interests are best protected through it, and is there a case for changing the Act to integrate Kay’s principles?

Vince Cable: I am hazily aware of this Act and what it says, but that would be covered by this fiduciary duty reference, would it not? We are doing that partly to establish whether the law is clear enough in respect of shareholder rights and the duties of managers. That links to the issue of fiduciary duty, which I have tried to answer your questions on already.

Q368 Mr Walker: Secretary of State, we have taken a lot of evidence and you yourself have said you are sceptical about the value of M and A. We have taken a lot of evidence and Kay himself talked about the transactional nature of investment nowadays, and the fact that it has gone too far down the transactional route. Do you feel that there are enough recommendations in Kay and enough detail in the Government response actually to change that culture and move away from a transactional focus that drives M and A and makes that an inevitable part of investment?

Vince Cable: As we have said before, the Kay Review did not really go very far into that territory and it may have been useful if we had got a stronger steer on it. It did not actually say a great deal about it. To amplify what I said before, there is a counter-view. I think the CBI, for example, argues that there are not enough mergers and acquisitions among medium-sized companies, because it thinks that would be a way of galvanising that sector of the economy. The premise there was that that kind of activity could be beneficial. I stated my own view, which was to be a bit sceptical about M and A activity and its wider values. There is a strong view in business—and I think genuinely, not just by self-interested people—that it has an important role to play.

Q369 Mr Walker: One area that Kay talked about, and that you mentioned earlier, was this idea of a public interest test for overseas takeovers. It is widely touted that the UK is probably more open than any other jurisdiction in the world to overseas takeovers. We have mentioned the issue of Cadbury, but I could list a whole slew of other takeovers over the years where UK companies have been taken over. Is that an area where you personally feel there is more scope for Government to get involved?

Vince Cable: No, I do not, and I have argued this with your Committee before. As a Government, we have rejected the Heseltine recommendation on foreign takeovers, and personally I think we should reject it. We should not be distinguishing between domestic and foreign ownership. It is not helpful, and some of our best companies are owned by “foreigners”—whatever that means these days. If you talk about Jaguar, Land Rover or Nissan, these are superb companies. They are not just good companies; they are very committed to Britain, and they invest heavily in R and D here. They see a future for this country. They see themselves as good corporate British citizens, whereas there are plenty of, essentially, British companies that have no attachment here at all. Distinguishing on the nationality of the owner is not useful and, on the contrary, the fact that Britain has a very good reputation for not being nationalistic stands us in very good stead when it comes to attracting good investors here.

Q370 Mr Walker: Just in terms of investment, a lot of the Kay Review focuses on the investors and financial intermediaries, so far as they sit on the buy side of the equation. There are very few recommendations or Government responses that relate to the sell side, and the culture in terms of the banks and institutions that are driving a lot of this process. I put it to you that, actually, the biggest change in culture over the last 20 years, which has moved us towards a transactional culture, has actually taken place in the banks, in the brokers and in the organisations that are selling these deals to businesses, management and their investors, rather than on the buy side. Is there not perhaps a need for the Government to be looking at that area, and is there a problem with the fact that that falls under the remit of the Treasury, rather than BIS, and therefore your Department is not able to set the agenda in that sense?

Vince Cable: I agree with your general point that the culture of financial transactions is being driven by the banking system, probably rather more than the things we are discussing here. We are not, as a Department, excluded from that. I have been very heavily involved in the arguments about banking reform and Vickers and electrification or whatever. In terms of the conduct of banking, Andrew Tyrie’s commission are the people looking at that. They seem to be coming out with some very sensible approaches and it is getting into exactly the question you described: they are looking at the culture of banking and the damaging effect that has had.

I would make one very specific point that does not relate to Kay, but is highly relevant, which is that what has caused so much damage with the SME community is not just the post-crisis problem of lack of capital;

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it is the fact that these institutions stripped out their relationship banking 10 or 15 years ago. They replaced their relationship managers with insurance salesmen; it was absolutely hopeless. It has affected the culture in a very damaging way. This, in a way, takes us back to the earlier part of the discussion about encouraging equity as opposed to debt. This is one way of avoiding the damaging influence of money-lending institutions, in that you have a stronger equity base for capital.

Q371 Mr Walker: I completely agree. I put it to you that we talk a lot about the incentives for management and for investors. The incentives for the sell side and for the bankers are going to be a crucial part of that and perhaps that is something for Andrew Tyrie's commission to look at. It is generally agreed that to address this area—particularly the stewardship issue—it is going to take a lot of cross-departmental work. Do you feel that, around the Cabinet table, there is a consensus on the direction of travel here?

Vince Cable: I think so—not narrowly on Kay, but on things like corporate governance as it related to executive pay we could have easily diverged. If you go back 15 months ago, there was quite a vigorous debate inside Government and with outside institutions about where we should go on all that, but we finished up in the same place, hence the legislation that you in Parliament have subsequently dealt with. The one issue that might have caused some disagreement was about quarterly reporting, but we are all agreed that that is unhelpful—the mandatory requirement. The problem of shifting it is not that there is difference within the Government; it is that we have got to get the European Union to go back on this, and we think that we are fairly close to getting it.

Q372 Mr Binley: Secretary of State, we have had discussions, as I have already mentioned, about the Cadbury takeover, but is not one of the lessons not to distinguish between home-based and foreign-based ownership, but to distinguish between hostile and non-hostile attacks, as it were, for mergers and takeovers? There is no doubt that hostile attacks have much more opportunity to be damaging because of the very fact that they are hostile to start with. I just wonder whether you could not make that distinguishing comment and whether, if we come back with some answers to your challenge, that might figure in your thinking.

Vince Cable: I am not sure how you distinguish with any clarity between hostile and non-hostile. One of the issues that arose in the Cadbury takeover, as you remember, was that the people who were being “attacked” were perfectly happy to sell their shares to the hedge funds, otherwise how did the hedge funds get the shares in the first place? The idea that this is a crime with victims does not quite fit the way that markets operate.

Q373 Mr Binley: With respect, do we not live in a world now, with arbitrage and so on, where you do not know who you sell your shares to? Is that not one of the problems?

Vince Cable: That is, I am sure, one of the problems. When I described some of the changes in the takeover panel's own principles, one of the things they do now do, in addition to the put-up-or-shut-up provisions and

the greater transparency, is to require the acquirer to state their intentions for the company in a much more explicit way, so you can identify—or the shareholders of the company that has been attacked, as it were, can identify—the objectives of the people who are trying to take them over. I agree that that does not solve the problem, necessarily, but it make the whole process a bit more transparent.

Q374 Paul Blomfield: I just wanted to pursue that point a little bit more. In answer to Robin, you said it was not helpful to distinguish between home-based and foreign-based ownership. You cited some very good examples of foreign-based owners who very much take a very positive role in the UK economy. Equally, I could cite to you, from the Sheffield steel industry, examples where foreign-based owners, as times get tough, retrench. When they retrench, they tend to retrench to the country of ownership for production. Do you not see any merit in the Government supporting UK-based ownership?

Vince Cable: I am not sure that what you say is true, actually. The Brinsworth Strip Mill is owned by Tata, is it not? It has shown at least as much commitment—

Q375 Paul Blomfield: I am acknowledging that there are examples of good foreign ownership but, equally, there are examples where that does not work, are there not?

Vince Cable: I just do not think it is true that overseas companies necessarily retreat to base in conditions of difficulty. If there is some hard evidence on that clearly that is significant, but I have never seen any, to be quite honest.

Q376 Paul Blomfield: So you do not think there is merit in encouraging UK ownership.

Vince Cable: I do want to encourage British entrepreneurs; that is a different point. We do want to encourage an entrepreneurial culture among our own people. There are problems with British entrepreneurs who grow to a certain size and then sell up. There is a genuine problem there, for which I do not think any of us totally understand the reasons. We do not produce our own Facebooks here; they get to a certain point and then sell out. It may well be that, in that particular industry, American investors will take them over, and that is a bit worrying, but not because the people who have taken them over are Americans, but because our own entrepreneurs do not have the incentive or the motive to stay the course, as it were. You are right to say that we need indigenous entrepreneurs and to encourage them, but I do not want to turn this into an anti-foreign investor thing.

Q377 Mr Walker: You are going to be publishing a progress report in the summer of 2014. What do you think is the minimum that should have happened by then?

Vince Cable: I would have thought that the minimum is that the investors' forum, which is at the heart of Kay's recommendations, would be up and running and functioning, and we would be able to see a discernible impact, and that the various statements of good conduct that have been issued by the trade bodies will be in place and will have been visibly acted upon. I would hope that, at roughly the same time, we would have a clear conclusion from the Law Commission, so we would have various pieces to put together a

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year before the end of the Parliament to be able to say, "Yes, things are moving".

Q378 Mr Walker: The majority of the Kay recommendations are quite vague on what the outcomes are going to be. Are there any specific targets that you would want to see hit, or any specific measures through which we, as a Committee, can hold the industry and the Government to account?

Vince Cable: You keep saying the recommendations are a bit vague. They are general and they do rely on trust and voluntary activities—this goes back to the very beginning. I think a lot of people were a bit surprised that he adopted that approach, but I do not quarrel with it, providing it does result in some change. As I say, we are setting up a mechanism to change it. I would be very disappointed if, within the next year or so, we have not, for example, changed the rules around quarterly reporting, because that is a very concrete thing that he has identified. It is in the power of Governments—not just ours—and it is a very tangible manifestation of a short-term-driven business culture.

Q379 Mr Walker: Who is responsible for taking that forward?

Vince Cable: It is our job to take that forward with European Ministers.

Q380 Chair: Just to conclude, Minister, you have said that, basically, these proposals rely, to a great degree, on trust and voluntary activity. Now, given the fact that this is an industry where trust and voluntary action in the public good has not exactly been very obvious, what would you do if you were satisfied, within a year or so, that this is not the right way forward?

Vince Cable: I am not sure I accept your point. There has been a collapse of trust in the banking system, for sure, after what has happened. I do not think that is true of the other institutional investors. After all, most of us still trust our savings to them. We do not try to bypass pension funds, even where we have the choice, and we do not try to bypass insurance companies; we still use them. We would not do it if there had been a collapse of confidence. The main task now is just to make sure that they do operate better in the interests of their shareholders and the original investors in them. That is what we are about. I do not totally share the premise of your question.

Q381 Chair: I find that rather odd given your comments that I read at the beginning of this session. You were not referring to just the banks then; you were talking about the industry in general.

Vince Cable: There are a lot of rogues. There is a lot of bad practice. There are a lot of bad companies, and in some sectors, we have seen this rampantly so. Banking is one and media, dare I suggest, may be another, and action is being taken to try to deal with those abuses. I did use strong language because there

are some serious abuses, but that does not mean that the whole system of private enterprise, in general, and of institutional investors, as another, is corrupt, rotten and falling apart, because it is not. There are some bad examples and we need to deal with them.

Q382 Chair: It is more than just bad practice though, is it not? There is an underlying belief that the financial services industry does not think long term; it only thinks short term. I would have assumed that some of your comments previously were designed to remedy that.

Vince Cable: It does not think only short term, but there is a short-term bias. Pension funds, by their very nature, think long term—they have to. The underlying problem we are trying to deal with is that there are savers who want to save for the long term. There are pension funds trying to invest for the long term and there are companies out there that want to borrow or get equity investment for the long term to make investments. Somewhere in the chain, there are short-term incentives, which is essentially what the Kay Review is all about—that that collective interest we all have in good long-term investments is being twisted or diluted by institutions that do not work properly. It is somewhere in this system of incentives that the various investment managers have. That was his major conclusion and it is what we are trying to address.

Q383 Chair: You have put your finger on the crucial problem. It is the managers of our investment who have a financial motivation for working and thinking short term. I come back to the point I made: if, after a year or so of examination, it is obvious that this is not changing, what will you do then?

Vince Cable: I do not have any problem with adopting tough regulatory solutions when voluntary methods have failed and we have demonstrated that in one or two areas, with executive pay being the most obvious one. It will be the same with takeovers, if it proves to be necessary. My approach to all these things—women on boards, and a lot of other things—is to try the voluntary approach and try to build up trust with the practitioners. If it fails, we can adopt more aggressive solutions, but let us try the voluntary approach first.

Q384 Chair: Thank you, Minister. I expect that we will come back to this some time before the end of this Parliament. We recognise that, certainly in terms of the pub companies, you, shall we say, were open-minded enough to accept our criticism and do something about it, so if we feel the need to take further action, we hope that you will be open-minded in the future to do something about it in the future as well.

Vince Cable: Definitely.

Chair: Thank you very much and we appreciate your contribution.

Written evidence

Written evidence submitted by the Government

1. In June 2011, the Secretary of State for Business commissioned Professor John Kay to undertake an independent review to examine investment in UK equity markets and its impact on the long-term performance and governance of UK quoted companies. This followed the Department's earlier call for evidence "A Long-Term Focus for Corporate Britain", launched in October 2010, which explored issues of economic short-termism in the UK. The responses to that call for evidence found that there was evidence of short-termism in UK equity markets and of some agency problems in the investment chain.

2. The Kay Review's principal focus was to ask how well equity markets are achieving their core purposes: to enhance the performance of UK companies (by facilitating investment and enabling effective governance and decision making in support of long-term profitability and growth); and to enable investors to benefit from this corporate activity in the form of returns from equity investment.

3. The Kay Report seeks to shift the culture of UK equity markets to ensure they support long-term investment, constructive relationships between companies and their investors, and sustainable value creation by British companies. It has been widely welcomed by business and the investment industry.

4. The Government published its response to the Kay Report in November 2012, welcoming the report, accepting its conclusions and setting out next steps for Government and regulators, and expectations of market participants. The response:

- endorsed 10 principles for equity markets to which market practitioners, Government and regulatory authorities should have regard, and the report's directions for market participants which follow from these principles;
- committed to working with the relevant regulatory authorities to explore further the Kay Report's directions for regulatory policy—to identify to what extent these directions are practical, what changes in the law or in regulation might be therefore be appropriate, and how these can best be delivered; and
- set out a number of steps the Government is already taking to deliver on the Kay Report's detailed recommendations, including:
 - completing reform of corporate narrative reporting to be higher quality, simpler, more relevant to users and more focussed on forward looking strategy;
 - pursuing reforms to the EU Transparency Directive which will remove mandatory quarterly reporting; and
 - promoting the revised edition of the Stewardship code (published in September 2012) which emphasises that stewardship should encompass engagement by investors on company strategy.

5. Many of the report's recommendations are for market participants, in particular companies and institutional investors. The Government response makes clear that the necessary changes in culture cannot simply be achieved through regulation, but rather through the development of good practice in the investment chain. The Government is therefore promoting Professor Kay's Good Practice Statements for company directors, asset managers and asset holders, as the starting point for industry-led standards of good practice.

6. The Kay Report's recommendations, and the Good Practice Statements, aim to deliver, among other things:

- more collective action by institutional shareholders, including via the establishment of an investors' forum,
- better disclosure of costs in the investment chain, transparency and fairness around the lending of securities,
- better alignment between pay and long-term performance for company directors and asset managers, and
- a greater focus on stewardship and engagement to create sustainable economic value in public companies—supported by trust-based relationships and alignment of interests through the investment chain.

7. The Government is now driving forward these recommendations, in particular by:

- challenging business and the investment industry bodies to respond to Professor Kay's Good Practice Statements for company directors, asset managers and asset holders, and give clear direction to their members that will promote the behaviour needed to restore trust and confidence in the investment chain;
- emphasising the principle that all investment intermediaries should act in good faith; in the best long-term interest of their clients or beneficiaries and in line with generally prevailing standards of decent behaviour, and that these obligations should not be contractually overridden;

- asking the FSA to ensure that their regulatory framework supports this principle and pursuing changes to regulation at EU level if this is required; and
- asking the Law Commission to review the legal obligations on investment intermediaries so that investors are clear that they cannot simply assume maximising short-term returns will meet their obligations to their clients.

8. The Government's commitment to take forward the recommendations of the Kay Report is part of a wider commitment to achieving sustainable, long-term economic growth. In particular:

- The Government's Industrial Strategy, launched in September 2012, set out a clear and ambitious vision for a long-term, strategic partnership between Government and industry, focusing on issues like access to finance, skills, innovation and government procurement, in specific sectors in which the UK has a competitive advantage, to ensure businesses have confidence to take long-term decisions.
- The Government has also taken steps to ensure that the new Competition and Markets Authority (CMA) takes an appropriately long-term view. It will have a duty to promote competition for the benefit of consumers—with the objective of supporting long-term growth built into its performance framework.

9. The Government response commits the Government to publish an update, in summer 2014, setting out what further progress has been achieved by government and others, to consider Professor Kay's directions for regulatory policy and to deliver his specific recommendations.

10. The Kay Report does not provide an exhaustive list of detailed reforms but rather provides a framework for further work to ensure investment in equity markets supports UK companies to deliver sustainable long-term economic growth. This will require a sustained commitment to reform from government, regulators and market participants. The Government therefore welcomes the Committee's inquiry as an important contribution to the debate about how to take forward Professor Kay's directions for market practice and regulatory policy, and how to develop and embed good practice throughout the investment chain.

24 January 2013

Written evidence submitted by Philip Goldenberg

1. INTRODUCTION

1.1 I am a solicitor specialising in Company Law, Corporate Finance and Corporate Governance. I was the Legal Adviser to the Royal Society of Arts' TOMORROW'S COMPANY Inquiry in the mid 1990s, and then advised the Government's Company Law Review on the topic of Directors, Shareholders and Stakeholders—I was responsible for the concept of "enlightened shareholder value" referred to in para 3.1 of the Kay Interim Report.

1.2 My general thoughts on this concept were fully set out in a Lecture I delivered to The Institute for Advanced Legal Studies in 1998.

1.3 I wish to comment on a particular topic in the Kay Report discussed at para 3.24 of the BIS Response.

2. SUBSTANCE

2.1 In that para 3.24, the BIS rightly point out that, as a consequence of the related explicit provisions of the 2006 Companies Act as regards directors' duties, directors of an offeree company may lawfully recommend to shareholders that they reject a bid at a premium to the pre-bid share price if they believe that the transaction will destroy value in the longer term or that the offer price does not reflect the fundamental value of the company.

2.2 Sadly, however, this approach is not followed in practice. Take-overs of listed companies are regulated by the Takeover Panel—effectively a cartel of the investment banks with no statutory or regulatory framework (it must be the only regulatory body which is recognised in, but wholly unaccountable under, statute law). And, as with all self-regulation, it favours the "self".

2.3 The Panel's City Code imposes a specific duty on offeree company directors to advise shareholders whether or not an offer price is fair and reasonable. But it does NOT, other than in the weakest generalities, qualify this by a statement of the law as regards directors' duties and set out by the BIS in para 3.24 of their Response.

2.4 As a consequence, City practice is to disregard these duties. The near-unanimous advice by investment bankers to directors of offeree companies is to focus solely and exclusively on price. This happened in the Kraft/Cadbury takeover, and I accordingly also attach for convenience the article on the Cadbury takeover which Mark Goyder (the Founder Director of the Centre for Tomorrow's Company) and I wrote for the Wall Street Journal—please see in particular the penultimate para under "Not Price Alone". Indeed, there was also an earlier case in which Greg Dyke wished to reject the BskyB bid for Manchester United (of which he was

then a Director) because he thought it incestuous for a football club to be owned by a broadcaster, but was overwhelmed by the erroneous advice by Manchester United's investment bankers (who may well have had their fee in mind).

3. RECOMMENDATION

The Committee is invited, in its Report, to recommend strongly that the Government require the Takeover Panel to make the legal position set out by the BIS in para 3.24 of its Response clear beyond peradventure by inserting an appropriate bold textbox in the City Code.

16 January 2013

Written evidence submitted by Standard Chartered Bank

1. We are pleased to submit our response to the Business, Innovation and Skills Committee call for evidence entitled The Kay Review of UK Equity Markets and Long-Term Decision Making. This submission is focused on Kay Review recommendations 3, 5, 15 and 17 as this where we believe we can add most value.

2. By way of background, Standard Chartered is a leading international bank, listed on the London and Hong Kong stock exchanges and is also listed in India (through the issue of Indian Depository Receipts). It has operated for over 150 years in some of the world's most dynamic markets and earns around 90% of its income and profits in Asia, Africa and the Middle East.

EXECUTIVE SUMMARY

3. As a major international bank with dual primary listings, it is our duty to deliver long term value to our shareholders. Standard Chartered's brand promise is "Here for good" which is a long term promise to our clients, customers and shareholders. As a well functioning board we will always strive to focus on the long term growth of the company while being mindful of the near term return factors and will seek to achieve right balance.

4. We believe that our investors have a good understanding of our strategy and long term focus. This is achieved by the significant commitment Standard Chartered demonstrates in engaging with our investors. We engage with our investors frequently, through forums such as the annual Chairman's governance dinner, analyst trips in various jurisdictions, twice yearly results presentations, and multiple meeting with our investors (further details are provided in Appendix 1 (section 3). We have a strong Investor Relations team of 10 who exist solely to communicate and build relationships with investors. We believe the Annual General Meeting provides a good forum for challenge and encourage shareholder attendance and engagement. Therefore any new rules regarding Investor Forums would need to be carefully constructed to ensure that it is complementary to the existing and highly successful Investor Relations engagement. It would not be feasible for all shareholders to be represented on this Forum. Different types of shareholders have different needs and therefore careful thought would need to be given into how membership is defined and controlled while adhering to the principle that all shareholders (within the Forum or not) should have the same access to company information and share the same rights.

5. Director's remuneration is a key topic and Standard Chartered has actively contributed to various consultations during 2012. Much has been achieved within the past few years with many financial services companies having implemented sensible levels of deferral in their remuneration policies. We understand the sentiment of what the Kay Review is intending but need to understand the unintended consequences. Please see Appendix 1 (section 5) for further details.

6. We agree that it is desirable for individual investors to hold shares directly on an electronic register. To achieve this, it is important to ensure that the chosen model for dematerialisation preserves the advantages of the current UK model. This includes direct ownership rights, transparency for issuers in relation to who owns their shares, the choice for shareholders regarding ownership arrangements (via an intermediary or directly on the register) and a continued ability for retail shareholders to trade on a "real-time" basis.

7. We hope that you find our response useful in your deliberations and would welcome having a continued dialogue in relation to this. In the meantime, please do not hesitate to contact me if there is any additional information you require.

Annemarie Durbin
Group Company Secretary

25 January 2013

APPENDIX 1

RESPONSES TO CALL FOR EVIDENCE

(3) An investors' forum should be established to facilitate collective engagement by investors in UK companies

3.1 Standard Chartered PLC (the "Company") proactively engages in ongoing dialogue with shareholders and we find that, in general, shareholders are very receptive to this approach. Dialogue occurs both informally and in scheduled forums as well as in relation to major corporate actions such as the 2009 appointment of our current Chairman, the 2010 listing in India and the 2010 rights issue. We maintain a dynamic shareholder engagement plan in relation to our investors. Senior management typically meet individually with our top 25 investors annually. On a biennial basis, we organise a trip to two or three core markets in which we operate. During these visits investors have an opportunity to meet local management and get a detailed understanding of how the Company operates the business on the ground. This is particularly important given that a large portion of our register is represented by UK or US investors who do not normally have the opportunity to see the Company operating on a day to day basis, and the fact that over 90% of our revenue and profits are generated outside the UK in our key markets of Asia, Africa and the Middle East. We are in regular contact with our investors at conferences, on roadshows, in one-to-one and group meetings or dinners, on reverse roadshows and we regularly respond to investor requests for information. We have a strong Investor Relations team of 10 who exist solely to communicate and build relationships with investors and we periodically conduct an investor perception study to gauge investors' views on Standard Chartered. In 2012 the Investor Relations team hosted a series of presentations focusing on our Asia businesses, Consumer Banking, Wholesale Banking and Group perspectives in China as part of the biennial Investor Trip last November. The event spanned over three days with presentations from senior management covering the scale of business opportunities in our key footprint markets, our progress so far and our plans for the future. Materials from the event are readily available on the IR website for the broader investment community.

3.2 We believe strongly that it is important to engage our shareholders in relation to our corporate governance practices as well as in relation to the investment proposition we offer. In addition to the investor meetings described above where we often talk through governance issues, annually the Chairman hosts a Governance dinner where investors are invited to join an open dialogue on our governance and management structure. The Chairman, the Chair of the Remuneration Committee, and the Group Company Secretary also meet individually with shareholder representative bodies (such as the ABI) as well as individual shareholders to discuss key governance issues. Furthermore, we participate in a broad range of industry conferences and other investor events to ensure all investors seeking access to the Company have plenty of opportunities to engage with us. The Chairman, Group Chief Executive, Group Finance Director and other members of the senior management team are regularly present at these investor events.

3.3 Standard Chartered's shareholder base consists of 28,000 shareholders on the UK register, 32,000 on the Indian register and 3,000 on the Hong Kong register. A large portion of these shareholders are small institutional and retail shareholders. We therefore believe strongly that minority shareholders should have access to information on the Group and be able to fully exercise their shareholder rights. The AGM has historically been the main forum for retail shareholders to meet the Directors of the Company, probe them on any issues and ask questions. Standard Chartered has always believed that the AGM is a key event and believes companies should continue to make it accessible to retail shareholders. Due to the international nature of our register we also offer an audio webcast of the AGM which can be accessed by all shareholders. Questions can be sent into the Company through a dedicated AGM email if shareholders are unable to attend and ask questions in person. Our Directors take shareholder engagement seriously which is evidenced by the fact that they ensure that they are available to "mingle" with shareholders after the AGM during refreshments. We have received feedback from shareholders that they really appreciate this gesture and time spent with Directors.

3.4 We therefore believe that any new rules regarding Investor Forum membership, meetings, engagement, communication, reporting and rights would need to be carefully constructed to ensure that it is complementary to existing investor communication methods and does not replace the existing and highly successful Investor Relations activity. It would not be feasible for all shareholders to be represented on this Forum. Different types of shareholders have different needs and therefore careful thought would need to be given into how membership is defined and controlled while adhering to the principle that all shareholders (within the Forum or not) should have the same access to company information and share the same rights.

(5) Companies should consult their major long-term investors over major board appointments

5.1 Standard Chartered does consult its major shareholders regarding major board appointments and believes that this practice represents good governance. One example of this was the 2006 appointment of Lord Davies as the chairman of Standard Chartered. Lord Davies had been an employee of the group for 15 years and held the role of group chief executive for the five years prior to his appointment as chairman. This appointment did not comply with the UK Code "comply or explain" principle that a CEO should not move into a chairman role for the same company.

However, we engaged with our institutional shareholders to understand their perspectives and to explain why we believed that this appointment was, given all the circumstances, in shareholders' best interests. It was

hugely beneficial to have stability of leadership between Lord Davies and Peter Sands (who moved to the group chief executive role) throughout the extreme turmoil in the banking sector during 2007 and 2008. Responding to institutional investor feedback, we did appoint a new independent deputy chairman at this time. This decision has also proven to be in shareholders' long term interests as it enabled the board to continue to perform effectively in 2009, despite Lord Davies stepping down to take a UK Government appointment. Looking back, this situation was a particularly good example of how "comply or explain" increases focus on the rationale and mitigation of corporate governance concerns; whereas a more arbitrary rule based system could result in company actions that do not benefit shareholders.

(15) Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business

15.1 Arguably the aims of Kay Review can and are already being achieved by sensible levels of deferral which can now be seen in many financial services companies. Many organisations already have shareholding guidelines in place. Deloitte's September 2012 remuneration study showed that most FTSE100 CEOs held 5x base salary in shares. Whilst understanding the sentiment expressed by the Kay Review, we suggest that care needs to be taken to avoid unintended consequences. For example, making executives retain shares could in effect encourage the wrong behaviours like incentivising them to leave the organisation to realise value from their locked in holdings. Alternatively executives nearing retirement could be tempted to take actions designed to drive up the share price in the short term.

15.2 It should also be noted that any reforms could create an uneven playing field. European banks could be at a competitive disadvantage if forced to adhere to EU/FSA/BIS rules globally irrespective of the location of executives. Standard Chartered competes for talent against local banks in Asia, Africa and the Middle East which do not have such constraints. There are also taxation (and securities) issues in many overseas jurisdictions in relation to equity ownership. For example executives may need to dispose of shares to pay for relevant taxes when share awards vest and/or are exercised and potentially subsequently when physical shares are held.

(17) The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register

17.1 We note the recent Proposal for European regulation on improving securities settlement in the European Union and on Central Securities Depositories (the "CSD Regulation"). We welcome the goals of the CSD Regulation in harmonising the regulation of CSDs and improving settlement efficiency across Europe, but are mindful to ensure this is not achieved across the wider European Union at the expense of retrograde steps for issuers or their shareholders here in the UK.

17.2 It is evident from Article 3(1) of the draft CSD Regulation that mandatory dematerialisation of securities will be introduced. We are aware of the benefits that a properly designed and implemented system of dematerialisation can deliver for the UK market; a move which we believe could meet this recommendation 17 of the Kay review. However, in moving to dematerialisation it is important to preserve the advantages of the current UK model, including direct ownership rights, transparency for issuers in relation to who owns their shares, the choice for shareholders regarding ownership arrangements (via an intermediary or directly on the register) and a continued ability for retail shareholders to trade on a "real-time" basis.

17.3 We understand that certain market participants, including the share registrars, are drawing up detailed proposals for how dematerialisation might best be delivered for the UK market and we are broadly supportive of their approach.

Written evidence submitted by Albion Ventures LLP

1. Albion Ventures ("Albion") welcomes the opportunity to comment on the Kay Review of Equity Markets and Long-Term Decision Making.

EXECUTIVE SUMMARY

2. Albion supports the objectives of the Kay Review, and broadly endorses the findings and recommendations of the final report. We believe the review to be an important and timely milestone; one that sets out important principles by which the financial services industry can start to rebuild public trust and promote long-term security across its activities.

3. There are elements within the report to which we would like to respond. Notably, while we agree that measures need to be taken to discourage short-term decision making, we do not believe that mandatory quarterly reporting obligations should be removed. Instead, companies should be encouraged to focus on long-term planning within these reports, moving away from a short-term focus.

4. We welcome the Kay Review's comments prioritising the character and quality of shareholder engagement. In addition, we feel that long-term substantial shareholders should have board representation, building an

informed, trust-based relationship through which they can hold the management to account. We believe it is important for all stakeholders that organisations managing long-term funds adopt a long-term view.

5. Albion itself already meets with many of the suggestions in the Kay report. This in part is due to taking an evergreen approach to funding, reinvesting proceeds for responsible, sustainable capital growth; we have always valued long-term security, performance and relationship continuity over a short term-approach.

6. We also uphold the values of integrity and reliability in our approach to corporate governance, as advocated by the Kay report; the average length of service of senior management at Albion is nine years, and we engage continually with all our stakeholders to enhance standards. Our well-attended shareholder meetings and the overall active, involved attitude of our investor base reflect this emphasis on communication.

ALBION VENTURES' MAIN AREAS FOR COMMENT

QUARTERLY REPORTING

7. Albion supports the Kay Review's general outlook that certain business cultures and practices can increase the pressure to make potentially lucrative but otherwise damaging short-term decisions. However, relating to performance measures the final report recommends that mandatory IMS (quarterly reporting) obligations be removed; grouping them under the umbrella of "excessively frequent" reporting. While we accept that some quarterly reporting will contribute to short-sighted business practices when the content has been "managed" to appear in the most positive light, we do not believe that the procedure should be removed altogether.

8. We feel strongly that shareholders should receive frequent, accurate and objective information, as part of a culture of transparency, inclusion and engagement. This helps to foster informed decision making on the part of an interested, active and long-term minded shareholder base. We believe that more information is better than less, and therefore take the view that quarterly reporting itself is not the root of this issue. Rather, the limiting element has been the nature of that reporting, erring towards the short-term view. We believe that companies should steer their quarterly reporting away from being what the Kay Report terms a "marketing speak" driven means of bringing in more capital, towards something much more balanced, objective and long-term minded. We see this as an important part of the wider shift towards a more responsible financial culture.

9. Additionally, we would like to draw the BIS committee's attention to a reporting model widespread in certain jurisdictions, notably Japan, in which quarterly information includes a rolling 12 month financial forecast. We feel that this model would help to avoid too much very short-term focus; Japanese investors certainly tend to be longer-term minded. Indeed, in the UK such forecasts are already made available to boards, so we believe that expanding this sphere of access to include the general market would be a valuable aid to transparency, and a spur to investors for taking a longer-term attitude.

SHAREHOLDER ENGAGEMENT

10. Albion both endorses the Kay Review's criticism of "shareholder engagement of superficial character and low quality", and agrees with the statement that "equity markets will function more effectively if there are more trust relationships which are based on voice and fewer trading relationships emphasising exit". From our own experience, we firmly believe that inclusive, responsible decision making—based on relationships of real character and high quality—is essential for security and sustainability in the financial services industry.

11. To help achieve this, we would recommend that long-term substantial shareholders should have representation on the boards of companies in which they invest. This practice supports shareholders' understanding of company strategy, gives them the "voice" that the Kay Report calls for, and provides a greater incentive for them to act in the company's long-term interest. Furthermore, it allows longstanding investors to have personal, reciprocal and trust-based relationships with the company management. This is not only a mutually beneficial working relationship, but a mechanism by which shareholders can "hold the management to account" over its actions.

12. Companies and markets are, of course, diverse, both in terms of models and attitudes. As such, there may be some resistance from institutions. However, we firmly believe that quality shareholder engagement is vital; long-term investors should always be considering the long-term interests of the companies in which they hold shares, as this is the practice which offers greatest benefit to all stakeholders.

ADDITIONAL COMMENTS

13. Aside from the main points already outlined, we would like to offer some additional observations. For example, we believe that to facilitate a move away from the culture of short-termism in the financial services industry, the importance of a company's objectives in achieving a stable business environment should be made more explicit. Long-term goals should always be a priority for financial services companies and enhancing the importance of such objectives should enable a switch in focus towards the longer term. This, in turn, should bring stability benefits, both for businesses individually as well as the wider business environment.

14. However, we believe that such changes should be cultural rather than legislative. When it is considering the recommendations of the final report, we would recommend the Business, Innovation and Skills Committee

to be wary of the potential for further legislation creep in subsequent years. It is vital that in the future, would-be investors are not deterred by excessive regulatory red tape or other investment barriers.

15. In addition, while we appreciate the thinking behind the proposal for an Investors' Forum, we question whether the need for collectivising shareholders is an appropriate focus for addressing the "disincentives to engagement" problem which the report describes. We do consider solidarity amongst investors as unnecessary and may even weaken the strength of the shareholder system, namely that shareholders vote and act as individuals.

16. We do request clarification from BIS over the extent of the proposed fiduciary standards recommended by the Kay Review. We would also welcome the opportunity to then comment more fully on this issue at a later date.

THE VCT APPROACH

17. We at Albion believe that the VCT model already meets much of the spirit of the Kay review. Due to the structure of the VCT model and the types of company the trusts invest in, VCT's are often more effective than other types of investment vehicles when it comes to shareholder engagement. In particular, Albion's evergreen approach and our policy of placing appropriately experienced members of staff onto the boards of the companies we invest in, means our shareholders expect us to take a more pro-active approach than is found elsewhere.

18. We strongly believe that long-term relationships are based on good communications and responsible corporate governance. As part of this philosophy, we at Albion remain highly conscious of all stakeholders across the board, from individual investors through to HM Treasury, a highly important stakeholder given the tax incentives that VCTs attract. As such, we greatly welcome the opportunity to continue the dialogue that has been opened by the Kay Review—both with the Government and our shareholders—on the subject of long-term decision making in the financial services industry.

19. Finally, we would encourage the BIS committee to consider the positive examples the VCT model can offer to the rest of the sector when it is analysing the findings of the Kay Review.

20. We are pleased to have had the opportunity to set out these comments on the Kay review. We look forward to the next stage and would be very happy to participate further if the need arises.

Patrick Reeve
Managing Partner
Albion Ventures LLP

17 January 2013

Written evidence submitted by Russell Investments

1. EXECUTIVE SUMMARY

1.1 Russell Investments welcomes the final report of the Kay Review and the Government's response to it, and is pleased to offer this response to the Business Innovation and Skills Committee's "Call for Evidence" issued on 12 December 2012.

1.2 The Review is concerned to address how well UK equity markets are achieving their core purposes:

- to enhance the performance of UK companies; and
- to enable savers to benefit from the activity of these businesses through returns to direct and indirect ownership of shares in UK companies.

Our response focuses on the second of these two purposes from our perspective as a fiduciary manager, asset manager and adviser to the asset owner community.

1.3 The UK equity market is but one component of the increasingly complex investment problem faced by asset owners. Increased complexity has understandably been accommodated through greater specialisation, both within the UK equity savings and investment chain and elsewhere. This has led, as Professor Kay identifies, to the development of multiple specialist firms eg custodians, investment consultants, proxy service providers, stock lenders, to deliver these services.

1.4 This proliferation presents challenges around the control and management of the chain and the array of specialist suppliers to that chain. In this response, we provide evidence that better control can be achieved through:

- further professionalising the asset owner community;
- encouraging structures that allow for more efficient and effective decision-making;
- creating scale within the asset owner community; and
- better aligning of incentives along the chain.

1.5 We submit that simplifying the chain is unlikely to be achievable in the context of the wider investment portfolios of which UK equities form only a part. A focus on ensuring better control and influence is brought to bear on the UK equity component (as well as other components) through the above mechanisms would be a more fruitful policy. We recommend that the Committee considers policy initiatives in these areas as it takes forward its consideration of the Kay Review and the Government's response.

1.6 In particular, we advocate that:

- as part of the response to Professor Kay's recommendation 9 (review the definition of fiduciary duty), the Committee reviews how asset owners can be better equipped to discharge that duty through acquisition of greater expertise, more effective delegation, and development of non-executive, oversight skills;
- as part of the response to recommendation 2 (the adoption of Good Practice Statements), Good Practice Statements are developed explicitly for the growing and diverse "Fiduciary management" segment, which may in the future be in control of substantial portions of asset owners' portfolios;
- the Committee considers policies that would encourage the consolidation of small asset owners to create greater scale in the asset owner community, which would support recommendations for greater engagement and long-term decision-making on the part of asset owners; and
- in considering recommendation 7 (application of fiduciary standards), the Committee specifically addresses the "responsibility gap" that is evident in transactional services, such as FX trading, to the investment chain.

2. CONTROLLING THE INVESTMENT CHAIN

2.1 Professor Kay talks extensively about the investment chain and the number of participants that now exist within the chain. He talks about:

"...the growth of transactional relationships and the erosion of relationships based on trust and confidence—leading to an expansion of costly intermediation activity in the investment chain."

He goes on to argue for an increase in trust and confidence in the investment chain. Whilst we applaud this sentiment we do not necessarily feel that an increase in participants is always a bad thing but we do agree that it is essential to control these participants, either through regulation or through appropriate incentive mechanisms or indeed a combination of the two.

2.2 The complexity of the investment problem faced by asset owners is well documented and so it is not unnatural to expect an increase in the number of specialist skills that are needed to navigate a way through. However the complexity of the system is a challenge and does lead to a wide range of problems. The Royal Society of Arts (RSA) has been developing a body of theory—referred to as "Cultural Theory" that has strong parallels with the problems faced by investors. Cultural theory considers social problems that have complex causes, multiple stakeholders and that are unlikely to be fully "solved" in the foreseeable future.

2.3 The following comments draw heavily on the ideas discussed by the Chief Executive of the RSA, Matthew Taylor in his annual speech to the Royal Society of Arts.¹

"We can also think of social power having three distinct forms: first, the downward power of hierarchical authority associated most strongly with the state; second, the lateral power of solidarity and shared values generally associated with the idea of community; and third, the upward power of individual aspirations..."

"Wicked problems are by definition both tough and multi-faceted so we need to draw on all these forms of social power to tackle them. When progress seems impossible, we revert to a fourth way of thinking about power and change: fatalism."

We can draw parallels between "wicked problems" in a social context and the issues we face in trying to control behaviour in the investment chain.

2.4 Our complex investment problems will not be solved with simple, one-dimensional solutions but require multiple perspectives to come together. In an attempt to find a solution we can begin to shape our answers using the framework of social power.

"...when it comes to complex and contested change, the hierarchical, solidaristic, individualistic and fatalistic perspectives are ever-present as competing diagnoses, dispositions and prescriptions."

2.5 In our case:

- the *hierarchical* power becomes the regulator who adopts the traditional controlling role, acting as a back-stop and creating some freedom for the participants to behave responsibly and differentiate themselves;

¹ Drawing on the work of Mary Douglas

- the lateral power of *solidarity* is the “industry” bodies that have the capacity to stand together and create good behaviour through voluntary codes of conduct. We have already seen good examples of this happening amongst some groups of agents, for example the T-Standard was designed by a group of transition managers to create an industry standard measure of total costs in the transition process (see paragraph 6.9);
- the upward power of *individualism* can be interpreted as the individual investor or asset owners, including collective investment vehicles which generally have a trustee (unit trust) or Board (OEIC) to look after the interests of the investor. The thrust of our individualism must be education; part of the solution is to empower individuals through education so that they can make more informed decisions about their investments. The aim is not to convert them into investment professionals but, at the very least, to help them appreciate such issues as time-horizon and what to expect from different investments.

2.6 The challenges identified by the Review will require each of the three powers; (1) regulators, (2) industry bodies and (3) individual investors and asset owners to input to the solution. We must strive to avoid the fourth way, fatalism, but no one power can affect the necessary change on its own.

2.7 The objective is to achieve greater control of a more complex investment chain, rather than to reduce the investment chain. As the UK equity market is but one component of investors’ challenge, initiatives designed to wind back to a simpler age are unlikely to achieve their aims.

2.8 Controlling longer investment chains requires greater skill, dynamism and dedication relative to simpler, shorter chains. Better control will ensure that each element of the chain is operating effectively, is rewarded commensurately for the amount of value preserved or created, and acts in concert effectively with other components. Effective control will preserve value from company to saver.

2.9 We see four primary means of developing structures which allow for better control:

- Professionalising the asset owner community;
- Encouraging structures that allow for better professional oversight of the assets;
- Creating scale within the asset owner community; and
- Better alignment of incentives along the chain.

3. PROFESSIONALISING THE ASSET OWNERS

3.1 Asset owners, comprising pension fund trustees, insurance companies and other entities which aggregate individuals’ savings, are a key link in the savings and investment chain. Ensuring that these entities are structured and motivated effectively to represent the needs of savers is therefore one of the foundations of success in ensuring the chain works effectively and in the public interest.

3.2 The trustees we work with are vigilant guardians of their beneficiaries’ interests, and the culture and ethos of independent trusteeship is to be cherished. The principles and regulations governing pension fund trustee selection are based on ensuring proper representation of the various stakeholders. This is an important and necessary principle and one that we support. However, stakeholder representation is not a sufficient condition to ensure that the trustee body has the investment expertise and decision-making skills that it requires to effectively oversee and control the investments.

3.3 The Russell survey² of investment decision-making by trustees provides evidence of this. Of the 300 funds surveyed:

- fewer than half have included a professional trustee; and
- out of an average of seven individuals in the trustee body, on average only 2.5 are deemed to have some degree of finance or investment expertise.

Anecdotally, from our experience, those who are deemed to have finance or investment expertise are often representatives of the finance function within the sponsor company. While this ensures a familiarity with the financial perspective and a clear capability to get to grips with the technical aspects, it does not always ensure a long-term saving investment perspective. Indeed, Professor’s Kay’s analysis of the financialisation of companies and the resulting behaviour is illuminating in this regard.

3.4 There are many consequences of this, as was eloquently described by Paul Myners in his 2001 review.³

“at the heart of the system, we often make wholly unrealistic demands of pension fund trustees. Our legal structures put them firmly centre-stage. They are being asked to take crucial investment decisions—yet many lack either the resources or the expertise. They are often unsupported by in-house staff, and are rarely paid.”

² The Evolution of Investment Decision-Making: 2011 Survey of 300 Defined Benefit Pension Funds, Sorca Kelly-Scholte & Shashank Kothare, February 2012

³ Institutional Investment in the United Kingdom: A Review, Paul Myners, 6 March 2001

He argues that, as a result:

- we place a heavy burden on the investment consultants who advise trustees;
- fund managers are being set objectives which, taken together, appear to bear little coherent relationship to the ultimate objective of the pension fund, namely to meet its pension obligations;
- risk controls for active managers are increasingly set in ways which give them little choice but to cling closely to stock market indices;
- there is extreme vagueness about the timescales over which fund managers' performance is to be judged with resulting short-termism in fund managers' approach to investment; and
- fund managers remain unnecessarily reluctant to take an activist stance in relation to corporate underperformance, even where this would be in their clients' financial interests.

These are all observations that resonate strongly with Professor Kay's perspective.

3.5 There is evidence that these shortcomings are costly in performance terms, ie in terms of extracting value from the fund's investments. A study by CEM Benchmarking⁴ finds a positive correlation between governance quality and fund performance: the value added through high quality governance could be as much as 2.4% per annum, adjusted for risk and expenses.

3.6 Lord Myners' diagnosis was that if trustees lack expertise collectively to make a decision, then either they must acquire the necessary expertise or delegate the decision. He made a specific recommendation that trustees should have an investment committee unless there is a good reason not to. Ten years on, the Russell surveys find not only that there remains a scarcity of investment expertise on trustee bodies, but also that little is being delegated:

- Of the funds surveyed, fewer than half (48%) had investment committees: in particular among smaller schemes only 22% reported having an investment committee;
- Across a range of different investment decisions, 70% or more of the respondents indicated that the trustee body retained direct control of that decision.

3.7 Policy response to this has been to encourage the adoption of the Myners Principles that came out of the review (on which there appears to be limited progress, based on the above evidence), and to increase levels of trustee training.

3.8 Unpaid lay trustees can, almost by definition, never become investment experts. Even if this were possible in the past, increased complexity makes it all but impossible today. Trustee training aimed at developing deep expertise across the vast range of investment issues encountered by pension funds is likely to be misplaced effort. Rather, trustee bodies require non-executive skills to discharge their function as overseers of the fund's investments.

3.9 However, in a series of roundtable discussions we held with pension funds,⁵ many funds told us that it was difficult for trustee boards to distinguish between ultimate responsibility for a decision and the ability to delegate immediate responsibility for that decision to someone else. The result is a tendency to retain direct control of much investment decision-making, or to get involved in delegated duties to an inappropriate level of detail, even where the necessary expertise for effective decision-making is lacking. This borne out by the Russell surveys, as described above.

3.10 A corollary of this observation is that training for trustees should focus as much on developing these non-executive skills as it does on educating them about the technical aspects of the various investment decisions for which they retain ultimate responsibility. Currently most training is more focused on the latter, and delivered by agents who are keen to demonstrate their expertise.

3.11 Professor Kay's recommendation 9 focuses on clarifying the concept of fiduciary duty:

"The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers."

In light of the evidence on this section we recommend that alongside this review the government considers how trustees can be better equipped to discharge that duty through acquisition of greater expertise, more effective delegation, and development of non-executive, oversight skills.

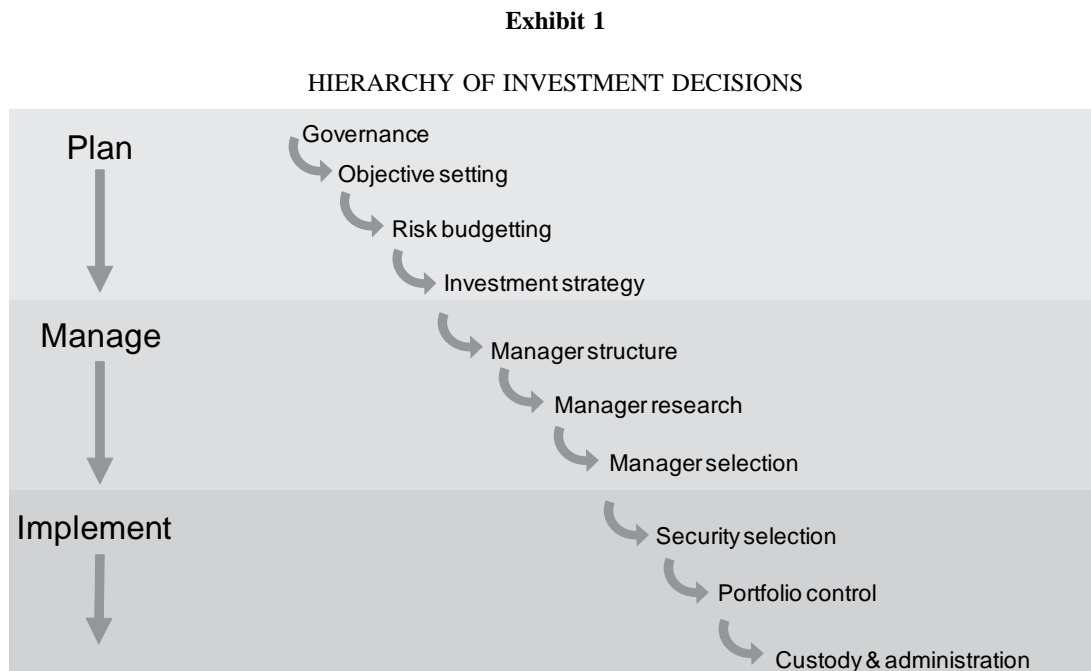
3.12 We have no evidence to suggest that insurance companies and asset owners are not appropriately professionalised. However we note the challenges, by virtue of these entities' ownership, around ensuring that these asset owners are incentivised towards the needs of savers rather than to the commercial needs of providers further down the chain.

⁴ The State of Global Pension Fund Governance Today: Board Competency Still a Problem, Keith Ambachsteer, Ronald Capelle, Hubert Lum, Working Paper June 2007.

⁵ Aspects of Good Investment Governance: Lessons from recent investor roundtables, Don Ezra, Sorca Kelly-Scholte and Shashank Kothare, February 2011

4. ENCOURAGING STRUCTURES FOR BETTER OVERSIGHT

4.1 A number of levels of decision-making are required when managing a pool of capital, such as a pension fund's assets. These decisions are shown in the Exhibit 1 below.



Asset owners are directly responsible for the higher level decisions, which appear in the top left of the exhibit. Investment managers, who manage portfolios of securities, make the decisions towards the lower right of the exhibit.

In the middle, the decisions taken can be described as “executive” in nature. They fall between the “director/board” decisions of the trustees and the “operational” decisions of the investment managers employed. For effective decision-making, the trustees need to both make a small number of high level decisions and also to exercise effective oversight of decisions made by others beneath them in the structure. So, broadly, trustees oversee the executive and the executive oversees the investment managers. The executive can include, for example, an investment committee, as discussed in Section 3 above.

4.2 In our work we often find that inadequate resources are devoted to this executive function. This can arise for a number of reasons:

- there may be unwillingness by trustees to delegate (the ultimate versus immediate responsibility issue described in paragraph 3.9 above);
- corporate streamlining may have removed company executives who in times past would naturally have performed this executive role for the trustees; and
- a strong investment consulting presence, although formally an advisory role, may have taken on a more executive rather than advisory role either implicitly or explicitly, as originally identified by Lord Myners (see 3.4 above).

4.3 One solution is to build an in-house executive. Well-resourced in-house executives are long-established at many of our largest pension schemes, and anecdotally many larger schemes are now seeking to extend their in-house teams. However, the cost of building this level of resource will be prohibitive for the long tail of smaller schemes in the UK.

4.4 The creation of greater scale among asset owners, as discussed in section 5 below, is one means of indirectly encouraging the development of better-resourced in-house executives.

4.5 An alternative response has evolved where some of these decisions are delegated to a third party. Several investment firms with a consulting heritage (including Russell) have offered a manager of investment managers service for some time. Trustees (clients) recognise that they are poor decision makers when investment manager

selection, monitoring and termination decisions are to be made. So the trustees delegate these decisions to expertise, retaining oversight of the appointment of the manager of managers provider.

4.6 Taking this one stage further, some higher level decisions, for example the regional disposition of equity holdings, can also be delegated. In effect, once the broad strategy is agreed the control of the chain implementing the strategy is delegated to a professional third party, and the trustees retain oversight responsibility. Russell offers this service. We believe that, properly structured, this represents an extension of asset owners' fiduciary reach through delegation to a professionalised executive resource.

4.7 The precise formulation of this type of service varies widely, and is now usually referred to as "fiduciary management" or "implemented consulting". Along with new entrants, many asset managers and traditional consultants have evolved their services and business models to provide fiduciary management services. There is evidence of increasing take-up and interest in these types of service, particularly among smaller schemes. The Russell survey of investment decision-making found that 15% of schemes now use some form of fiduciary management, with this figure rising to 26% of the smaller scheme (<£500 million) respondents.

4.8 While representing increased professionalisation and a step-change in the level of resource devoted to high level control of the chain, fiduciary management does present some potential challenges, notably:

- Ensuring that asset owners remain engaged given the increased distance between them and the companies in which they invest;
- Introducing the risk of misalignment of incentives if mandates are poorly specified, or if the fiduciary manager's commercial interests do not align with those of the asset owner.

4.9 The evolution of fiduciary management in the Netherlands, where the concept was first created, is instructive. The early phase of fiduciary management saw a concentration in a small number of providers. A number of disappointments in the outcomes from early fiduciary management could be traced to a misalignment of incentives between the asset owners and the fiduciary management providers, where the providers' commercial interests drove investment decisions that were not consistent with asset owner preferences. This experience has informed the development of the market in the Netherlands. As active participants in this market, we can attest that asset owners look for greater engagement around the mandate definition and accountability, more transparency on portfolio holdings, costs and fees, and independent checks and balances on the activities of the fiduciary manager.

4.10 There are also important variations in the structures under which these types of services are provided. Some are provided under investment management agreements, others under advisory agreements. Accountability and the requirement to act as a fiduciary are clear in the former, less clear in the latter.

4.11 In *Directions for Government and Regulators*, Kay recommends that regulation should emphasise issues of structure and incentives rather than control of behaviour. We strongly endorse this recommendation, and would suggest its applicability in the context of our comments in this section. In particular, we encourage the creation of Good Practice Statements for this growing and diverse segment which may be in control of substantial portions of asset owners portfolios.

5. CREATING SCALE IN THE ASSET OWNER COMMUNITY

5.1 Professor Kay observes that the UK equity investor community is fragmented. This fragmentation is in evidence in the asset owner community. For example, the vast majority of UK defined benefit schemes are small: the 2012 Purple Book published by The Pensions Regulator indicates that out of a total of 6,316 schemes included in its dataset:

- 2,260 have fewer than 100 members;
- 2,828 have between 100 and 999 members; and
- (the remaining 1,228 have at least 1,000 members).

Given that the vast majority of UK defined benefit schemes are now closed to new members or future accrual, funds are set to get even smaller in the future. The defined contribution segment is further fragmented between contract-based and trust-based arrangements, and asset sizes as yet remain considerably smaller than for defined benefit schemes.

5.2 As well as more efficient cost structures, larger asset owners tend to have stronger governance. For example, the Russell survey of investment decision-making found that larger funds:

- have better access to expert resource and advice: taking together the number of finance or investment professionals on the trustee body or the investment committee, as well as any full-time in-house investment staff:
 - funds with assets in excess of £500 million have on average five expert individuals; whereas
 - the smallest funds (<£100 million) with less than £100 million in assets have only 2.5 individuals;
- are more likely to have an investment committee:

- 69% of large schemes (>£500 million) have investment committees; versus
- just 22% for small schemes (<£500 million).
- spend more time in absolute terms on investment issues: trustee boards and their investment committees spend:
 - just over 25 hours a year on investment issues for larger funds (>£500 million); versus
 - just 7.5 hours for the smallest funds (<£100 million).
- are more likely to have a more ambitious investment strategy: measured on complexity scale from 0–100 (least to most complex):
 - large funds (>£500 million) score 69; versus
 - 44 for the smallest funds (<£100 million).

As such, larger funds are better placed to control the investment chain and ensure that value is preserved for the end saver.

5.3 We submit that these larger fund scale efficiencies enable some, but quite a small proportion, of asset owners to engage more effectively with a number of the recommendations made by Professor Kay: for example developing and promoting a more expansive form of stewardship (Recommendations 1 & 2), participating in a forum for collective engagement (Recommendation 3).

5.4 Smaller asset owners could be encouraged to merge to facilitate the creation of scale. In several other countries, notably the Netherlands and Scandinavia, there has been strong encouragement for such smaller schemes to merge or pool their resources in industry-wide plans. In Australia, market forces have consolidated super funds to the point where there are very few small operators left. Current UK legislation makes it possible for smaller plans to join together, but there has been very little movement in that direction. We propose that the government considers incentives that would encourage consolidation. This aligns with Kay’s diagnosis that policy should focus on issues of structure. We expect that this would require a review of trust law and potential legal obstacles to consolidation, where we are not competent to comment further.

6. BETTER ALIGNMENT OF INCENTIVES ALONG THE CHAIN

6.1 Alignment of interest along the investment chain is patchy at best. The current system of incentives motivates participants to focus either on revenue (profit) maximisation, at the expense of investment outcomes for the investor, or on a time period that is far shorter than is optimal for most investors.

6.2 The problems with our current system on incentives can be separated into two distinct areas:

- the timing issue, where parts of the investment chain are incentivised to maintain a short-term focus, despite the ability of investors to take a long-term view, and
- the reward issue, where asset managers and agents are incentivised to behave in a way that is not always in the best financial interests of the investor.

These issues are all well understood by Professor Kay and a number of examples of this type of behaviour are highlighted throughout his report and the Government’s response.

6.3 The timing issue arises in a variety of different situations in the world of pension financing. Trustees are currently driven to focus on the short-term impact of market related valuations on their funding level (and hence the sponsor’s balance sheet) rather than on their real responsibility which is to provide the actual pension payments to beneficiaries; a series of, as yet, unknown payments over 40 or more years. Such a long-term investor would not necessarily wish to focus on government bonds when yields are so low if it felt there was a better chance of generating appropriate income streams from other assets, albeit that the value of such assets might suffer greater short-term volatility.⁶ Current regulatory and accounting practice encourages the short-term funding level volatility perspective, and the banking community has further encouraged corporate sponsors to adopt this perspective. This is one instance of what Professor Kay describes as “sales masquerading as advice”.

6.4 This short-term focus is also encouraged by the business models of asset managers who are generally incentivised to maximise the volume of assets they gather rather than focus on good, long-term outcomes for their investors. Their behaviour is designed to attract and then retain assets. Behavioural studies amongst retail investors demonstrate that they tend to invest new money in the latest hot performer but rarely move money away until the performance is significantly below benchmark. A successful manager need only produce short bursts of good performance to attract assets and hence profits and then seek to avoid the sort of underperformance that would cause those assets to be lost.

6.5 As Kay recognises, one of the main stumbling blocks in trying to change this behaviour is the concept of fiduciary duty. Many participants in the investment chain constrain themselves within a very narrow interpretation of fiduciary duty based on previous judgements, particularly *Cowan v Scargill* [1985], which many advisers have taken out of context and used to focus attention on short-term underperformance rather than the potential for long-term outperformance. If fiduciary duty is used to penalise a manager for following

⁶ Help! We are running out of gilts, Sorca Kelly-Scholte, February 2012

a good long-term theme that lags behind their peer group in the short-term then it is no surprise that their behaviour is adversely affected.

6.6 Conversely a lack of fiduciary care is the key culprit in a number of areas where the behaviour of third party agents engaged in the investment chain has come under scrutiny. In particular we see some evidence of “sharp” behaviour in the areas of currency management where the exchange rates charged to investors look suspect compared to what might have been achieved elsewhere in the market at the time. Studies by Russell have estimated the cost of this sharp practice to asset owners to be of the order of nine basis points per annum.⁷

6.7 However it is not all bad news. In some areas, the industry has acted on its own to improve the behaviour of agents. For example, the leading players in the transition management industry have come together and have created the T-Standard, an industry standard for measuring total costs during the transition process. This initiative has significantly improved transparency around the whole process of moving from one manager to another.

6.8 Another example of behaviour that is not aligned along the investment chain is the concept of “closet indexing”. Professor Kay observes:

“...that some active asset managers, faced with the need to deliver short-term relative performance, will resort to ‘closet indexing’, ie selecting and managing their equity portfolio to minimise tracking error from their performance benchmark.”

This is one of the reasons that has been cited as an explanation of why low risk stocks have not underperformed high risk stocks. The risk adjusted return premium associated with low volatility stocks is well documented.⁸ One of the most plausible explanations is that stocks with low absolute volatility introduce into a portfolio a high level of risk, relative to the benchmark against which managers are monitored. Asset managers are thus inclined to ignore an area of the market that could provide better outcomes for their investors.

6.9 As such we strongly endorse Professor Kay’s recommendations for the clarification of fiduciary duty (Recommendation 9), and the application of fiduciary standards to all relationships in the investment chain (Recommendation 7). Encouraging a truly long-term focus on investment-decision making requires that focus to come from all parts of the chain. We have focused on the primary controllers of the chain, the asset owners, earlier in this submission. We further recommend that the Committee specifically addresses the “responsibility gap” that is evident in transactional services, such as FX trading, to the investment chain.

7. ABOUT RUSSELL

7.1 Russell Investments (Russell) is a global asset manager and one of only a few firms that offer actively managed, multi-asset, multi-manager portfolios and services that include advice, investments and implementation. Working with institutional investors, financial advisors and individuals, our core capabilities extend across capital markets insights, manager research, portfolio construction, portfolio implementation and Indexes.

7.2 As of 31 December 2012, we managed over \$162 billion in assets for 2,400 institutional clients, and over 580 independent distribution partners and advisors globally. We advise \$2.4 trillion in assets (as of 30 Jun 12). We have researched investment managers for forty years, in recent years meeting annually with more than 2,200 managers around the world. Through our implementation services business, we traded more than \$1.5 trillion in 2011.

7.3 We are headquartered in Seattle, Washington, USA, and also have offices around the world including Amsterdam, Auckland, Beijing, Chicago, Dubai, Frankfurt, London, Melbourne, Milan, New York, Paris, San Francisco, Seoul, Singapore, Sydney, Tokyo and Toronto.

8. SUMMARY

8.1 Russell Investment welcomes the final report of the Kay Review and the Government’s response to it, and supports the Review’s recommendation the regulations should emphasise issues of structure and incentives rather than control behaviour. We have focused in this response on how better control on the investment chain should be encouraged, and the structures which are in place to control that chain.

8.2 We find evidence that there are potential benefits from:

- further professionalising the asset owner community;
- encouraging structures, for example in the fiduciary management segment, that allow for more efficient and effective decision-making;
- creating scale within the asset owner community; and
- better aligning of incentives along the chain.

8.3 In particular, we advocate that:

⁷ Still overpaying for FX?, Lloyd Raynor, May 2012

⁸ Defensive Equity: is the market mispricing risk? Bob Collie, John Osborn, July 2011

- as part of the response to Professor Kay’s recommendation 9 (review the definition of fiduciary duty), the Committee reviews how asset owners can be better equipped to discharge that duty through acquisition of greater expertise, more effective delegation, and development of non-executive, oversight skills;
- as part of the response to recommendation 2 (the adoption of Good Practice Statements), Good Practice Statements are developed explicitly for the growing and diverse “Fiduciary management” segment, which may in the future be in control of substantial portions of asset owners’ portfolios;
- the Committee considers policies that would encourage the consolidation of small asset owners to create greater scale in the asset owner community, which would support recommendations for greater engagement and long-term decision-making on the part of asset owners; and
- in considering recommendation 7 (application of fiduciary standards), the Committee specifically addresses the “responsibility gap” that is evident in FX trading and other transactional services to the investment chain.

Mike Clark, Sorca Kelly-Scholte and Crispin Lace

January 2013

Written evidence submitted by Aviva plc

EXECUTIVE SUMMARY

As the UK’s largest insurer and owner of a global asset management business with assets under management in excess of £370 billion, Aviva is able to speak as both the owner of, and investor of capital in the market.

We welcome the opportunity to participate in the Committee’s inquiry into Professor Kay’s Review and the Government’s response. We believe that, although Professor Kay produced a thorough and thoughtful analysis of the causes of short-termism in the equity markets, the study failed to fully examine the role of other participants in the investment chain that have a significant influence on the way companies are structured and develop their strategies.

Both Professor Kay and the Secretary of State have made several welcome proposals, for example on narrative reporting, ending quarterly reporting and the establishment of a new investment forum to reinvigorate collective engagement. We welcome these proposals as they fit with our investment beliefs, which are centred on being long term, engaged, active investors running low turnover, focused portfolios.

However, by failing to provide recommendations that address all the participants that influence the investment chain, or its inherent tensions and commercial conflicts, neither the review nor the government’s response sufficiently address the underlying causes of why the market is so short term. For example, it misses the opportunity to encourage investment consultants to oversee the way asset holders and their managers engage in stewardship and to examine the significant role played by sell side brokers.

This submission will give a brief overview of the causes of short termism in the capital markets and will then take each Kay recommendation in turn that we believe should be revised or expanded and will conclude with a series of policy recommendations to the Committee.

1. INTRODUCTION

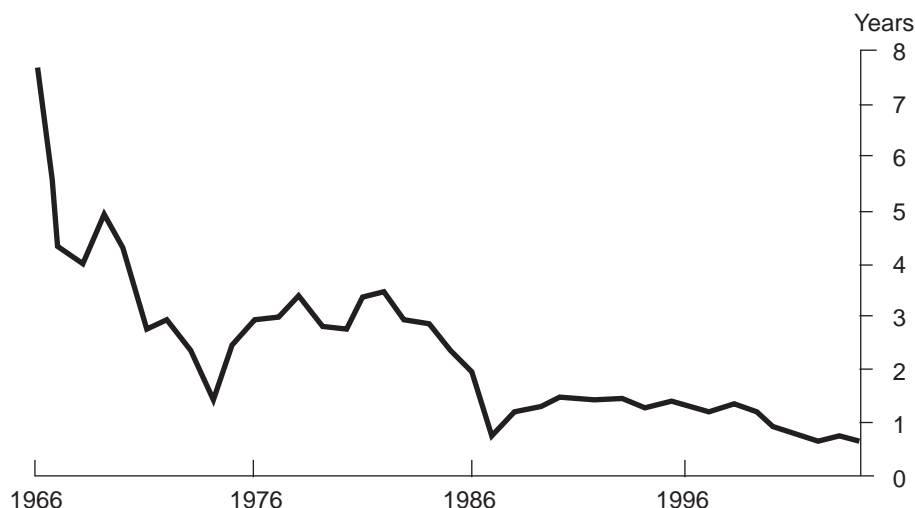
1.1 As a largely long-term, risk-averse equity investor, we are investing for our clients for the long-term. Looking at the broader dynamic in the capital markets, however, the pressures are clearly to the short term, which ultimately affects both investor and company behaviour.

1.2 We therefore welcome the debate about the role that long term investors should play in terms of stability, enabling corporations to focus on long-term strategic decisions and supporting economic growth. This must be significant if good long-term corporate investment opportunities (requiring a higher initial capital investment) that have a lower expected return, but a higher NPV (increase in shareholders’ wealth), are being passed up for faster and less value added alternatives.

1.3 At a headline level a distinction needs to be drawn between those who mainly trade shares and those who commit material amounts of capital to companies through the markets. Proprietary and principle traders that buy or sell equities or substitute instruments, often with their own capital, including hedge funds and others with very high portfolio turnover, such as high frequency traders, tend to be driven by short term market trends and turn over their portfolios rapidly. Those that invest will also buy and sell equities but tend to hold them for the long term based on their analysis of the prospects of the company and their perception of the underlying performance.

1.4 The Bank of England’s Andrew Haldane has highlighted⁹ the sharp decline in average holding periods for UK equities since the mid-60s from a period of almost eight years to just seven and a half months in 2007, a trend that is reflected in the US and other international equity markets:

⁹ “Patience and Finance” (September 2010), Bank of England



Source: London Stock Exchange

1.5 However, the seven and a half month figure does not offer a clear insight into the current state of play. Data from Tabb Group, UK National Statistics and the London Stock Exchange, shows that about two thirds of the turnover in UK equities is accounted for by hedge funds and high-frequency traders. By contrast the average holding periods of more traditional long-only funds in the past decade, who hold a more significant proportion of assets, have varied from 29 to 46 months, although this is still less than it was in the mid-60s.

1.6 Amongst the issues that the review highlighted, of particular interest in this context was the impact of technological advances and automated trading on investment. We believe that this dynamic and the developments that have been seen not only in the context of high frequency trading but also financial product development are particularly significant elements of the short-term orientation of the capital markets.

1.7 Looking back at the origins of high-frequency trading, after London moved from the trading floor to electronic trading in 1986, in what was known as the Big Bang, the average number of daily trades at the London Stock Exchange rose from around 20,000 trades to 839,244 with a peak in excess of 900,000 in 2007, although the crisis has impacted that trend. This is just the market equity volume and does not capture the full picture of related trading in, for example, contracts for differences (CFDs) and other related instruments. It is important, therefore, to recognise the range of parallel and connected trading strategies that exist and the fact that by 2007 Europe had become the most important region in the global derivatives market, with 44% of the global outstanding volume (significantly higher than its share in equities and bonds).

1.8 Compared to estimates of 35% to 60% in the UK, in the US capital markets, it has been suggested that HFT can account for up to 56% to 75% of dollar trading volume in US equities.¹⁰ The US Flash Crash in May 2010 was foreshadowed in the Black Monday crash of 1987. Computerised trading, high frequency traders and what is known as “order flow toxicity”,¹¹ have been attributed with creating the biggest one-day point decline on an intraday basis in Dow Jones Industrial Average history.¹²

1.9 While proponents of high-frequency trading argue that it provides liquidity to the market, there is evidence to the contrary.¹³ Amongst other issues, not only is high-frequency trading positively correlated to share price volatility,¹⁴ which HFTs exploit aggressively, but the general liquidity argument (clearly not borne out in the flash crash) is called into question. However, this must not be taken to mean that all short term investment activities are a problem, although valid concerns continue about the volume and impact of HFT.¹⁵

1.10 There is also the risk that high frequency traders can create mispricing which is then exploited to the disadvantage of ordinary investors.¹⁶

1.11 We therefore feel that steps need to be taken to curb the focus on and trends around HFT that seem to dominate the capital markets, although we are firmly opposed to the EU’s proposed Financial Transaction Tax, which would be both damaging to long term risk averse investors and London, as well as ineffective in raising the (net) revenues envisaged (See Appendix 1). More broadly, these issues form part of the wider, inherent or

¹⁰ See for example: <http://www.bloomberg.com/news/2011-10-05/with-high-speed-trading-market-cannot-hold-commentary-by-mark-buchanan.html> or <http://xtiburon.com/finance/how-high-frequency-trading-affects-the-market/>

¹¹ “The Microstructure of the „Flash Crash: Flow Toxicity, Liquidity Crashes and the Probability of Informed Trading” (2011) Easley et al, *The Journal of Portfolio Management*, Vol. 37, No. 2

¹² “Findings Regarding the Market Events of May 6, 2010” (Sept 2010), US SEC and CFTC

¹³ “High Frequency Trading, Stock Volatility and Price Discovery” (2010), F Zhang, Yale School of Management

¹⁴ See also “An Empirical Study of Volatility and Trading Volume Dynamics Using High-Frequency Data” (2010) Lu and Lin; “High Frequency Traders, News and Volatility” (2011) Martinez and Rosu; and “Where is the Value in High Frequency Trading” (2011) Cartea and Penalva

¹⁵ e.g. “High Frequency Trading: The growing Threat of Rogue Trading” (2011) Weber, London Business School

¹⁶ “A Dysfunctional Role of High Frequency Trading in Electronic Markets” (2011), R Jarrow and P Protter

endogenous risks that financialisation, the increase in speculation and decrease in investing, the growth of derivatives and use of leverage, the practice of shadow banking and lack of transparency, and institutions that are “too big to fail” all link together to create.

1.12 The practical issues for long-term investors, the trends being seen in asset allocation, and the issues of myopia and short-termism are apparent not only in the market’s increasing focus on high frequency trading, the broader level of portfolio turnover and falling holding periods, but also in the incentives of both market participants and corporate managers.

1.13 Dynamics such as short corporate reporting cycles/milestones and short-term performance measurement of investment portfolios are factors that both feed off and contribute to the short-term orientation of the capital markets and, in some cases, the behaviour of companies.

1.14 As the regulatory and standards frameworks, incentives and practice have all converged towards accommodating shorter time horizons, behaviours have normalised around and exacerbated that and the dynamic has become self-perpetuating, with increasing emphasis on immediacy and trading. This was neatly summed up by the founder of one US trading house who observed, in the context of the US flash crash, that “Over \$1 trillion of market value evaporates in less than 15 minutes and people say, “Who is to blame?”. No one is to blame. This is the market that we have. This is the by product of a market structure that has gone horribly wrong.”¹⁷

1.15 A recent McKinsey survey¹⁸ found that most executives believed that their companies were too loss averse in their approach. Two-thirds of the respondents indicated that their companies underinvested in product development,¹⁹ and more than half that they underinvested in sales and marketing and in the financing of start-ups for new products or new markets. This should be of significant interest to policymakers as, as the authors note, these are not just missed opportunities for individual companies: the investment dearth hurts whole economies and job creation efforts as well. To solely blame the capital markets, however, would be unreasonable; they are one piece of the jigsaw.

2. THE STEWARDSHIP CODE

2.1 The Kay Review recommended that the Stewardship Code should be expanded to focus on more strategic issues as well as corporate governance. An interest in and assessment of strategy, competitive positioning, operational efficiency and the leadership of businesses, clearly form part of the active investment process and approach we deem necessary for long-term investment.

2.2 The Stewardship Code sets out clear good practice and although there are clearly examples of effective practice and activity in equity investment, the integration of stewardship activities and what those activities are deemed to involve varies between fund management houses. Except for the most focused funds and listed turnaround vehicles, which often have highly concentrated portfolios and a relatively high level of resource per investment, the levels of resource that are available or indeed viable mean that a selective approach and prioritisation is needed. This is particularly true when spread across hundreds or indeed thousands of investments globally.

2.3 The take up and/or disclosure on the Code by asset owners has been more muted than amongst asset managers. This is an area where considerable uncertainty and lack of conviction still exists. Policymakers need to build on the solid foundations provided by the UK’s Stewardship Code and, amongst other things, the Pensions Regulator should be asked to re-examine its own regulations and to re-task its Investor Governance Group to take a more proactive interest and review their guidance around the Myner’s Principles. This work should also take account of market developments and how these frameworks should accommodate trends, such as that towards Fiduciary Management.

2.4 Furthermore, policy-makers should establish mechanisms that promote, encourage and require investors to maintain an appropriate oversight role of companies; for example, investors could be required to publicly disclose their voting record and pension trustees to report to their beneficiaries on how their ownership rights have been exercised.

2.5 There should also be regulatory enforcement measures of the stewardship codes and improved accountability of voting agencies, which have considerable power to either influence or control a substantial portion of the market at shareholder meetings. The voting recommendations of voting agencies are based on best practice, but cannot take sufficient account of individual circumstances. In some instances, this creates a box-ticking approach to corporate governance. This situation could be improved if proxy voting agencies were to explain their processes and explain the rationale for their voting decisions.

2.6 Responsible ownership is a non-excludable public good, ie the benefits of engagement are enjoyed by all owners regardless of whether they behave as responsible long term owners. Consequently, the vast majority of profit maximising commercial fund management institutions free ride and either do not do stewardship at

¹⁷ “Speed-addicted traders dominate today’s stock market” (2010) Los Angeles Times—http://www.themistrading.com/article_files/0000/0557/051610LosAngelesTimes.pdf

¹⁸ “A bias against investment?” (2011), Kholler et al, McKinsey Quarterly

¹⁹ In this context see: “Innovation and Performance in British-based Manufacturing Industries—a Policy Analysis” (2002) Cox and Frenz

all, or invest only token resources in this work. Professor Kay’s review does not consider how to significantly increase either the economic demand for, or the financial funding of stewardship. In general, it is assumed that fund managers will be responsible and accept their public interest role for them to conduct stewardship and voluntarily invest more in their stewardship work. This is misguided at best and economically naive at worst.

2.7 Fortunately, as Professor Kay recognises, there is no shortage of money in the system for financing the work of the various market intermediaries; global commission spend is between \$25–\$33 billion²⁰ In the UK, commission flows are overseen by the FSA and to control what fund managers spend this money on, the FSA has established a series of tests that fund managers have to apply before funding their research with commission (as this is generated from a small percentage charge on their client’s assets under management rather than from their own balance sheet).

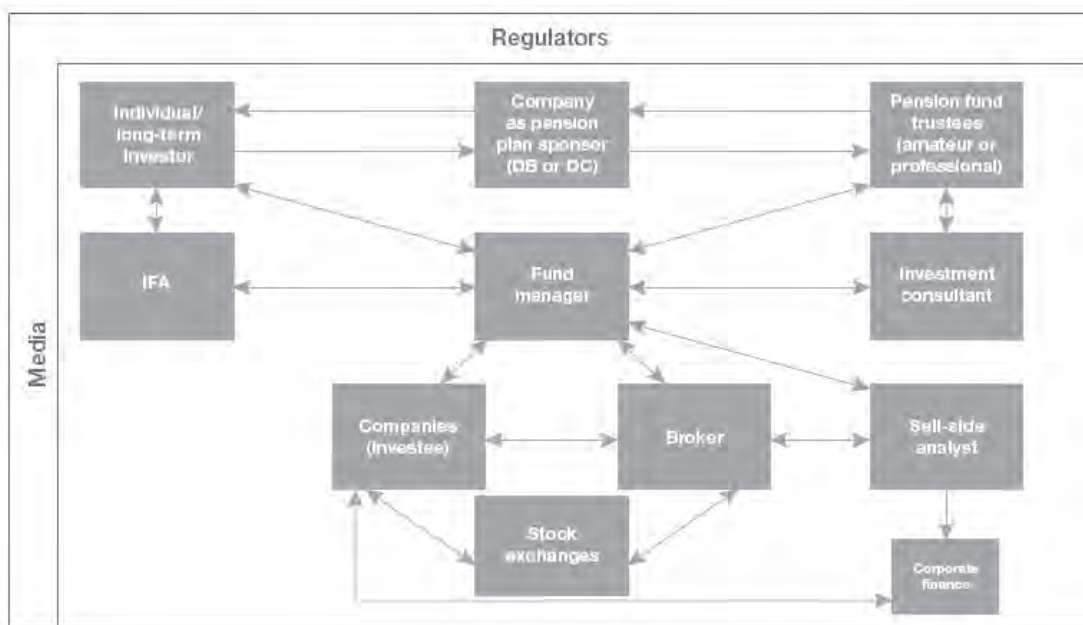
2.8 A few fund managers—including Aviva Investors—are directing this research commission towards brokers and independent research providers of long term investment research, voting advice and stewardship work. We are clear that investment stewardship passes these tests and adds value to investment decisions.

2.9 We believe that if policy-makers were to take the following four steps, then it would significantly increase the scale of stewardship resources in the market and fundamentally transform the delivery of long term investment analysis and investor stewardship:

- I. Policy-makers could clarify that long term investment research that is orientated towards good stewardship behaviour by investors can be paid for in this way.
- II. Policy-makers could suggest as a guide that it is good practice for a material proportion of the commission research (say 10–25%) to be spent in this way.
- III. Policy-makers could say that it is good practice for fund managers to be transparent to their clients that this was taking place.
- IV. Policy-makers could say that it is good practice for clients to be allowed to opt out of this, as long as they are clear to their beneficial owners what their rationale is for so doing.

3. GOOD PRACTICE STATEMENTS FOR COMPANY DIRECTORS, ASSET MANAGERS AND ASSET HOLDERS

3.1 The Good Practice Statements are welcome but fail to cover all relevant players in the capital market. The below diagram represents the impacts and interactions of incentives across the capital system. The arrows represent the direction of these impacts:



Source: Tomorrow’s Company, 2012

²⁰ Source: Frost Consulting, July 2012

3.2 Tomorrow's Company conducted a piece of research on potential issues for long-term stewardship and the alignment of incentives in partnership with Aviva Investors and found that potential conflicts of interest included:

3.2.1 Pension fund trustees and investment consultants

- Investment consultants tend to charge a fixed hourly rate and therefore have an incentive to be active in order to maximise their income. They therefore offer an increasingly wide range of services that they encourage trustees to use.
- Pension fund trustees will monitor the performance of their investment consultants according to a number of criteria that are not generally related to the fund's performance. It can be argued that this is necessary as investment consultants are not the investment decision-makers, but it does create a misalignment of interests.
- The degree to which investment consultants take into account factors relating to the long-term sustainability of companies is dependent on: the degree to which pension fund trustees wish to take them into account; and the cost of maintaining dedicated research teams and the lack of good long-term comparable data.

3.2.2. Investment consultants and fund managers

- Investment consultants have differing views on the key aspect of their role which adds most value for their pension fund clients. Some believe it is through advice on asset allocation while others believe it is through the fund manager selection process.
- There is an opportunity to generate substantial income through the fund manager selection process, so consultants may be incentivised to encourage fund manager turnover.

3.2.3 Pension fund trustees and fund managers

- The close and frequent monitoring of fund management performance by trustees can result in fund managers feeling pressured to maintain high levels of short-term performance relative to the benchmark to retain funds.
- 66% of pension funds formally review fund manager performance every quarter (92% annually or less), despite the key investment period for trustees appearing to be longer than a rolling or calendar year for 62% of them.²¹ This can create incentives that affect fund managers' approach to risk taking.

3.2.4 Sell-side analysts, brokers and fund managers

- Brokers' remuneration is directly tied to trading volumes. As a result they have a powerful incentive to encourage market activity.
- Even when sell-side analysts are aware of corporate governance or sustainability concerns, these analysts do not report this in their reports to buy-side analysts for fear of losing access to those boards

3.2.5 Corporate financiers and sell-side analysts

- As highlighted by the SEC in the US, analysts who work within the umbrella of a larger investment bank may have a potential conflict of interest around IPOs and new rights issues. The existence of such a relationship should not be taken to automatically mean an analysts' research is biased as there are strict codes of conduct, but research has shown that analysts may still feel under pressure to produce positive reports on the client company.²²

3.2.6 Corporate financiers and investee companies

- Corporate financiers' incentives are weighted towards deal completion. This can lead to a misalignment of interests as investment bankers' motivation to complete a deal may ignore what is in the longer-term interests of the company and its shareholders.

3.2.7 Fund managers, stock exchanges and investee companies

- Nearly half of all exchanges are companies listed on their own exchange and are therefore subject to shareholder pressure to maximise returns. The largest sources of revenue for demutualised, for-profit stock exchanges are reliant on market activity. This results in an incentive for exchanges to create inducements for trading activity.

3.3 In short, there is a lack of alignment between incentives, the interests of beneficiaries and business strategy. The criteria on which performance and hence reward is based are still too often founded on excessively short-term measures.

3.4 Simple measures could be implemented to align these incentives, for example: fund manager performance should be reviewed over longer time horizons than the typical quarterly cycle; excessive reliance on measuring performance relative to a market index should be reduced; pension funds should have voting and engagement policies that should be integrated into the investment process; shareowner activism should be given more weight in the selection and retention of fund managers and other matters; all advisors to institutional investors

²¹ "NAPF/IMA Short-Termism Study Report" (2004) MORI

²² See: US Securities and Exchange Commission. "Analysing Analyst Recommendations". Available at: <http://www.sec.gov/investor/pubs/analysts.htm>

should have a duty to proactively raise ESG issues and encourage adherence to the Stewardship Code; fund management contracts and fund managers' performance should include an evaluation of long-term ability to beat benchmarks; investment consultants' fee structures should not reward them for moving clients between fund managers; and within companies the implementation of strong cultural norms should be supported by independent whistleblowing mechanisms, overseen by professional bodies who offer the whistleblower appropriate protection.

4 THE SCALE AND EFFECTIVENESS OF MERGER ACTIVITY OF AND BY UK COMPANIES SHOULD BE KEPT UNDER CAREFUL REVIEW BY BIS AND BY COMPANIES THEMSELVES;

4.1 The role of incentives in this context is particularly important. Half or more of the mergers, acquisitions, and alliances that take place, fail to create significant shareholder value both in our experience and according to much of the research that has been undertaken on major deals.²³ For some time now, academics have flagged that company size is the factor that has the highest and most significant positive correlation with levels of executive pay.²⁴ This is echoed in academic work on UK M&A,²⁵ which has highlighted the significant and substantial executive pay increases, in excess of those generated by the growth in firm size, consequent upon mergers.

4.2 A way needs to be found to break this dynamic and re-align the incentives and economic interests of all participants in taking a longer-term approach. This applies not just to capital markets participants but to Boards of directors and their remuneration committees.

5 ASSET MANAGERS SHOULD MAKE FULL DISCLOSURE OF ALL COSTS, INCLUDING ACTUAL OR ESTIMATED TRANSACTION COSTS, AND PERFORMANCE FEES CHARGED TO THE FUND;

5.1 Looking at the question of whether and how asset managers should be more transparent, we quite understand the concerns around, for example, some fee structures.²⁶ This broad area is one that we are generally interested in seeing explored and debated further.

5.2 We support the Good Practice Statements recommended by Professor Kay and welcome the initiatives on cost transparency by the ABI and the Investment Managers Association and are complying with both.

6 MANDATORY IMS (QUARTERLY REPORTING) OBLIGATIONS SHOULD BE REMOVED;

6.1 We welcome the proposal to amend the Directive on Transparency Requirements for Listed Companies so that the requirements to produce interim management statements and quarterly reports are abolished. Such short term reporting cycles contribute to short-term thinking and can discourage investment for the long-term, given the impact that could have on short-term performance. It is also important to recognise the effects of peer pressure and competition between companies in this context.²⁷

6.2 Unilever Plc is often cited as an example of the hurdles companies have to overcome and mindset needed in breaking away from short term dynamics. Their move away from providing regular short-term guidance to embed a longer-term approach and practices was welcome and interesting. Initially the response from short term investors pushed the share price down around 10%, but it subsequently outperformed.²⁸ This highlights the importance of recognising that the dynamic here should not be characterised as just a capital markets issue. Unilever is not alone though in having sought to face up to this challenge and, looking at more cyclical businesses, others that would be worth exploring the issues with might include Aggreko Plc or Marshalls Plc.

6.3 On reporting more widely, the International Financial Reporting Standards (IFRS) are pro-cyclical in nature and played a notable role in facilitating and exacerbating both the dynamic and behaviours that drove the credit bubble and the subsequent crisis. Despite a common assertion of some standard setters, IFRS are not just presentational, they have real world effects, not just for pensions, capital management, behavioural biases, risk taking, and ability to be prudent but also, and not least, financial product innovation. The effects and problems have arisen both as a result of how the standards have been implemented and their effects on accounts. Not least, critical concepts like prudence and accounting conservatism have been superseded by a compliance orientated model. Concepts like the "true and fair view" have also been diluted. IFRS compliance allows significant discretionary scope within fair values. The standards have also resulted in the Companies Act accounting requirements being obfuscated, eg in relation to distributable reserves and dividends. From an investor perspective, a significant proportion of bank capital raising over the crisis went to redress precisely the results of that.

6.4 Looking at the broader accounting frameworks, long-term investors are interested not just in the decision usefulness model pursued by accounting standard setters, which is more orientated towards the trading markets

²³ See "Deals that create value" (2001) Biesharr et al. or "Why do acquisitions so often destroy Shareholder Value?" (2002) PA Consulting Group or "Deals from Hell: M&A Lessons That Rise Above the Ashes" (2005) R Bruner

²⁴ "How Much Does Performance Matter? A Meta-Analysis of CEO Pay Studies" (2000) Tosi et al.

²⁵ See for example "Merger Activity and Executive Pay" (2002) Gima et al.

²⁶ "Fund Management Fees" (2010) Terry Smith (<http://www.terrysmithblog.com/straight-talking/2010/09/fund-management-fees.html>)

²⁷ See for example <http://www.ft.com/cms/s/0/5d6c466c-6a00-11e0-86e4-00144feab49a.html#axzz1dOaOWc00>

²⁸ http://www.mckinsey.com/en/Features/Capitalism/Paul_Polman.aspx

than it is to corporate stewardship or to long-term ownership and investment. As the preliminary report of The Sharman Inquiry²⁹ noted, investors and “quite a lot of others” have raised questions about the suitability of IFRS accounts as a basis for assessing the solvency of businesses. As the report notes, overall, capital management is important to us as shareholders. However, IAS 1 disclosures are not generally providing what long-term shareholders want, although they could in theory be used to do so.

7 HIGH QUALITY, SUCCINCT NARRATIVE REPORTING SHOULD BE STRONGLY ENCOURAGED;

7.1 It is extremely difficult for any within the investment chain to demonstrate the value of non-financial information without widespread reporting on these areas by companies, in accordance with a consistent framework and standards.

7.2 Information should be disclosed in an integrated manner with strategy, risk and performance on: remuneration and incentive plans, material sustainability issues and the culture and values of a company.

7.3 The current framework and practices mean that many companies are failing to provide the level of information needed for investors to be able to judge the sustainability of businesses, affecting long-term strategic analysis. Globally, of 20,000 publicly listed companies recently reviewed through Bloomberg’s database, less than one in five publicly reported on even a single item of quantitative data on environmental, social or governance issues.³⁰

8 REMUNERATION

8.1 Most institutional client mandates tend to run for a minimum of three years. However, despite the long term nature of the liabilities institutions face, a norm for fund manager incentives is to have one- and three-year rolling performance horizons, ie the short and medium term, but not the long term. Although the dynamic is not always so simple, asset managers know that if they under-perform for a short period within this time they could be replaced. Therefore, some asset managers may take risks to get the required returns over a shorter time frame.³¹ Efforts, such as that of the Universities Superannuation Scheme, have been made in the past to devise longer term mandates but the need to plug pension scheme deficits has, in recent times, been the greater priority and so aggressive pursuit of short term performance continues.

8.2 According to National Employment Savings Trust (NEST) chief investment officer, Mark Fawcett, improving companies through corporate governance will remain “a fantasy” until pension trustee’s better align their managers’ incentives. Speaking at the OECD—WPC World Pensions and Investments Forum in December 2010, Fawcett suggested that pension scheme trustees are too focused on short term returns by hiring and firing fund managers on a three year cycle, whereas they should be looking at five years as a minimum, maybe ten. Fawcett maintains that “until pension funds start behaving the right way by aligning the incentives for fund managers... the idea that corporate governance is going to make a change is unrealistic.”³²

8.3 We believe that some Trustees consider it just as much a risk to award long term mandates as to not remove under-performing fund managers before their mandates are completed. However, as it takes time to discern the extent to which a fund manager’s performance is attributable to luck or skill, we consider it often inappropriate for managers to be judged solely on their short term performance. Indeed, over time as luck evens out, skill, where it exists, will shine through. Academics have, in the past,³³ examined the process in which asset owners hire and fire their fund managers and found a tendency to hire managers who had recently performed well and fire managers who had recently performed badly. The point of note was that the fired managers, on average, subsequently outperformed those hired, albeit marginally, notwithstanding the sizeable transition costs incurred in changing managers.

9. RECOMMENDATIONS

There are four key areas that need to be addressed in order for the capital market to deliver on long-termism and sustainability. These are:

- Investor advocacy influence
 - (a.) Sustainability or CSR report should be put to a vote at a company’s AGM on a comply or explain basis.
 - (b.) Policy-makers should establish mechanisms that promote, encourage and require investors to maintain appropriate oversight role of companies; for example, investors could be required to publicly disclose their voting record and pension trustees to report to their beneficiaries on how their ownership rights have been exercised.
 - (c.) Regulatory enforcement measures of the Stewardship Code.

²⁹ “Going Concern and Liquidity Risks: Lessons for Companies and Auditors—Preliminary Report and Recommendations of the panel of Inquiry” (2011) The Sharman Inquiry

³⁰ <http://www.guardian.co.uk/sustainable-business/aviva-chief-city-failure-sustainability>

³¹ See for example “Employment Risk, Compensation Incentives and Managerial Risk taking—Evidence from the Mutual Fund Industry” (2007) Kempf et al.

³² See Professional Pensions, 15 December 2010

³³ See for example “The Selection and Termination of Investment Management Firms by Plan Sponsors” (2008) Goyal and Wahal

- (d.) Regulation and improved accountability of voting agencies.
- Incentives of all players in the capital markets
 - (a.) Fund manager performance should be reviewed over longer time horizons than the typical quarterly cycle.
 - (b.) Excessive reliance on measuring performance relative to a market index should be reduced.
 - (c.) Pension funds should have voting and engagement policies that should be integrated into the investment process.
 - (d.) Shareowner activism should be given more weight in the selection and retention of fund managers and other matters.
 - (e.) Implementation of strong cultural norms supported by independent whistleblowing mechanisms, overseen by professional bodies who offer the whistleblower appropriate protection.
 - (f.) All advisors to institutional investors should have a duty to proactively raise ESG issues and encourage adherence to the Stewardship Code.
 - (g.) Fund management contracts and fund managers' performance should include an evaluation of long-term ability to beat benchmarks.
 - (h.) Investment consultants' fee structures should not reward them for moving clients between fund managers.
- Availability of market information
 - (a.) Policy-makers could clarify that long term investment research that is orientated towards good stewardship behaviour by investors can be paid for in this way.
 - (b.) Policy-makers could suggest as a guide that it is good practice for a material proportion of the commission research (say 10–25%) to be spent in this way.
 - (c.) Policy-makers could say that it is good practice for fund managers to be transparent to their clients that this was taking place.
 - (d.) Policy-makers could say that it is good practice for clients to be allowed to opt out of this, as long as they are clear to their beneficial owners what their rationale is for so doing.
 - (e.) Disclosure from investors and their agents on integration of ESG issues into the investment process.
 - (f.) Integrated narrative reporting should be required from all listed companies on a comply or explain basis.
- Training and education
 - (a.) Fund manager and analyst training centres eg the Chartered Financial Analyst Institute should use their syllabus and charterholder exam to look at how sustainable development work of companies may enhance corporate valuation.

Steve Waygood
Chief Responsible Investment Officer, Aviva Investors
17 January 2013

Supplementary written evidence submitted by Aviva plc

FINANCING LONG-TERM INVESTMENT RESEARCH

A proposal to increase investor stewardship

Among the most significant capital market failures is the failure of investors to be long term in their investment analysis and then behave as responsible owners—or stewards—of listed companies.

This lack of long term stewardship has been identified as an economic problem by successive Government reviews [Cadbury (1991); Hampel (1998); Walker (2009); Kay (2011)]. It is also considered by many experts to have been a significant contributory factor to the financial crisis (Walker, 2009).

The specific market failure is that responsible ownership is a non-excludable public good, ie the benefits of engagement are enjoyed by all owners regardless of whether they behave as responsible long term owners. Consequently, the vast majority of profit maximising commercial fund management institutions free ride and either do not do stewardship at all, or invest only token resources in this work.

Stewardship is under-funded and arguably profoundly so. We estimate that the average budget of a FTSE 100 company for compliance with the Corporate Governance Code is c. £5million per annum in comparison with the average budget of the top 100 fund managers on Stewardship, which is in the order of £120k.

This is not a discussion of equals. How can investors support leading companies that conduct thorough stewardship, or—perhaps more importantly—challenge the laggards, when the resources that they invest in this area are practically insignificant?

As noted, there has been considerable work in this area, yet Professor Kay's recent Review of Equity Markets and long-term decision making surprisingly does not consider how to significantly increase either the economic demand for, or the financial funding of stewardship. In general, it is assumed that fund managers will be responsible and accept their public interest role for them to conduct stewardship and voluntarily invest more in their stewardship work. This is misguided at best and economically naive at worst. Unfortunately, without demand from beneficiaries and a financial funding solution, the scale of investment stewardship will be piecemeal and disproportionately low. Investor stewardship makes financial sense for fund managers as it improves the long-term health of their funds but they are not currently equipped with the research that will allow them to pursue long-term investment strategies.

Fortunately, as Professor Kay recognises, there is no shortage of money in the system for financing the work of the various market intermediaries. Equity commissions are attached to every trade, which despite belonging to the asset manager's client are spent by the asset manager. Most equity commissions are split into two parts: execution (for the physical cost of trading and executing the transaction) and non-execution (for all other services including investment research). The latter can be used to buy research from any type of provider and this global research spend amounts to \$22 billion per year (Source: Frost Consulting, July 2012).

A few fund managers—including Aviva Investors—are directing this research commission towards brokers and independent research providers of long term investment research, voting advice and stewardship work. We are clear that such investment in stewardship adds value to investment decisions and is in the long term interests of our clients. However, this approach remains uncommon and those fund managers that do utilise this mechanism tend to spend only a few percentage points of their research commission in this way.

We believe that if the FCA were to take the following four steps, then it would significantly increase the scale of stewardship resources in the market and fundamentally transform the delivery of long term investment analysis and investor stewardship:

1. The FCA could clarify that long term investment research that is orientated towards good stewardship behaviour by investors can be paid for in this way.
2. The FCA could suggest as a guide that it is good practice for a material proportion of the commission research (say 10–25%) to be spent in this way.
3. The FCA could say that it is good practice for fund managers to be transparent to their clients that this was taking place.
4. The FCA could say that it is good practice for clients to be allowed to opt out of this, as long as they are clear to their beneficial owners what their rationale is for so doing.

This would have the following benefits:

- The market for stewardship would be transformed with materially more resources flowing into this work.
- Companies would benefit from engaged, informed and responsible owners raising any concerns at an early point without the need to use the press to highlight their issue.
- The end owners of the assets and, therefore, the beneficiaries of the stewardship work, would be financing the stewardship on their assets through their trading commission.
- The government would be creating an enabling environment for responsible capitalism at no cost to the exchequer and with no long term regulatory burden.

*Steve Waygood
Chief Responsible Investment Officer
Aviva Investors
18 March 2013*

Written evidence submitted by FairPensions

SUMMARY

- The Kay Review correctly concludes that there is a mismatch between the long-term interests of savers such as pension funds and the short-term incentives of the investment intermediaries managing their money.
- Ways of addressing this misalignment include legal mechanisms (ie fiduciary duties), financial mechanisms (ie remuneration design) and market mechanisms (ie consumer pressure & accountability). The Kay Review makes strong proposals on the first two of these three, but has less to say about the third. This is an area which would benefit from further policy intervention, for example to strengthen savers' rights to information about their investments.

- We strongly welcome the Kay Review’s proposals on investors’ fiduciary obligations:
 - Clarification of *what* these duties mean—in particular, that they do not oblige fiduciary investors to maximise short-term profits at any cost—is overdue. We support the decision to refer this matter to the Law Commission, which we hope and expect will be empowered to recommend statutory clarification.
 - Kay is right to argue that fiduciary standards of care should apply to all those managing other people’s money. We are pleased that the government accepts this in principle, but have some concerns that the wording of its revised Good Practice Statements may inadvertently water down the standards to be applied.
- The Stewardship Code is an important vehicle for promoting long-term, responsible ownership by institutional investors. It has so far been very successful in gaining acceptance by the investment industry, but less successful in generating demonstrable behaviour change. We believe its potential could be enhanced by:
 - strengthening the Code in a number of areas, eg management of conflicts of interest, attention to systemic risk, and emphasis on factors beyond financial results;
 - providing for independent monitoring of adherence to the Code’s principles, to be reported to parliament annually; and
 - building the capacity of pension funds and underlying pension savers to hold their investment agents to account for their stewardship activity.
- We agree with Kay that “high quality, succinct narrative reporting” is an important tool to enable investors to engage on issues of long-term strategy. We are concerned that the government’s current proposals are unlikely to make any significant difference to the quality of reporting.

ABOUT FAIR PENSIONS

1. FairPensions is a registered charity that works to promote active share-ownership by institutional investors in the interests of their beneficiaries and of society as a whole. Our particular focus is on encouraging shareholder engagement with listed companies to ensure effective management of environmental, social and corporate governance (ESG) risks which may affect long-term financial returns.

2. We are a member organisation. Our members include bodies representing pension savers, leading UK charities and thousands of individual pension fund members. We are independent of industry and are funded primarily by grants from charitable foundations and trusts.

3. Fair Pensions has been closely involved with the Kay Review from its inception through to the government’s response. In particular, our research on institutional investors’ fiduciary duties has been influential in shaping the Review’s recommendations. Accordingly our evidence focuses on the Review’s recommendations regarding fiduciary duty, although we also comment on other areas which fall within our expertise.

INTRODUCTION: ANALYSIS OF THE PROBLEM OF SHORT-TERMISM

4. We agree with the Kay Review’s analysis that resolving the problem of short-termism is not simply a matter of enhancing the influence of “long-term” investors (such as pension funds) and stemming the rise of “short-term” investors (such as high frequency traders). Rather, there are underlying structural problems with equity markets which cause theoretically long-term investors to behave in a short-term way.

5. Likewise, we agree that promoting more effective “stewardship” of companies by investors is not simply a matter of encouraging more shareholder engagement. For instance, in the run-up to the financial crisis, shareholder engagement with major financial institutions was not simply insufficient but actively damaging. Increased leverage and short-termist business models were often justified in the name of shareholder value, and (as far as we can ascertain) only one major asset manager voted against the takeover of ABN-AMRO by RBS.

6. In the recent FRC review of the Stewardship Code, many companies felt that “*some shareholders still seemed to focus too much on specific issues of a short-term nature*”.³⁴ Similarly, in a survey of ten large European pension funds, the funds estimated their ideal time horizon at 23 years and their actual time horizon at six years.³⁵ There is clearly a misalignment between the inherently long-term financial interests of pension savers and the often short-term outlooks of those managing their money.

³⁴ FRC, December 2011, ‘Developments in Corporate Governance 2011: The impact and implementation of the UK Corporate Governance and Stewardship Codes’. Available at <http://www.frc.org.uk/images/uploaded/documents/Developments%20in%20Corporate%20Governance%2020116.pdf>

³⁵ Hesse, 2008, ‘Long-term and sustainable pension investments: A study of leading European pension funds’. See <http://bit.ly/uaPQdd>

7. There are three complementary mechanisms for addressing this “principal/agent” problem:

- Legal mechanisms: ensuring that all those managing other people’s money have fiduciary duties to act in their best interests, and that these duties are understood in a way which promotes those interests over the long-term.
- Remuneration: ensuring that the pay of investment intermediaries is structured in a way which aligns with the long-term interests of beneficiaries and does not create perverse incentives to focus exclusively on short-term share price movements.
- Consumer pressure: forging a stronger link between investment institutions and underlying savers, so that those with a real interest in long-term performance are able to hold their agents to account directly. This parallels the government’s approach to executive pay, which has focussed on giving shareholders the tools to hold managers to account.

8. In our view, the Kay Review’s recommendations are strong on the first two of these three levers: we particularly welcome moves towards clarification of institutional investors’ fiduciary duties. The Review has less to say about the third lever; this is an area which would benefit from further policy thinking.

1. FIDUCIARY DUTIES

a. *Clarifying the content of fiduciary duties (Recommendation 9)*

9. We welcome the Kay Review’s recommendation for a Law Commission review of the application of fiduciary duties to investment. Pension fund trustees have a fiduciary duty to act in the best interests of their beneficiaries. (The extent to which similar duties apply to other investment intermediaries is discussed below.) This duty should be part of the solution to short-termism in equity markets, but it has too often been part of the problem.

The problem

10. Fiduciary investors tend to assume that their legal duties begin and end with maximising returns, and this in turn tends to be interpreted in terms of short-term returns relative to a benchmark. In our experience, this contributes to an excessive focus on short-term share price movements and to the neglect of factors which are not easily monetisable, including:

- environmental, social and governance (ESG) factors with implications for companies’ long-term financial value;
- systemic risks (be it risky lending in the financial sector or the implications of climate change) with potential financial impacts that far outweigh the effects of individual funds’ relative performance; and
- non-financial factors, such as beneficiaries’ ethical views or the implications of investments for their quality of life or community.

11. Some examples of this problem from our own experience include:

- One large UK pension scheme was given legal advice suggesting that their policy of exercising voting rights could breach their fiduciary duties if they could not demonstrate that the costs incurred were justified by monetisable benefits to that individual scheme. Since the benefits of stewardship almost inevitably accrue to the market as a whole, this contributes to a “free-rider” problem which holds back the shift towards a stewardship culture.
- We are aware of fund managers who lost contracts in the 1990s because they saw the “dotcom bubble” for what it was and refused to invest in tech stocks. Although with hindsight this was clearly a prudent long-term strategy, it led such managers to underperform their peers in the short-term. Many pension funds assumed they would be failing in their fiduciary duties if they did not respond to this by hiring a more orthodox manager. It is not unreasonable to suppose that some funds may have suffered loss as a result.
- One officer of a multi-employer pension fund recounts seeking legal advice on whether, when voting on a hostile takeover, they could take account of the fact that some of their beneficiaries might lose their jobs. The response was that this was not a relevant consideration: the trustees’ fiduciary duty bound them only to consider the price they would be paid for their shares.

Response to the Kay Review’s proposed solution

12. Fair Pensions has advocated statutory clarification to confirm that institutional investors *may* have regard to a wider range of factors than is commonly assumed. We have produced draft legislation illustrating how this could be done, modelled on section 172 of the Companies Act 2006 which sought to achieve a similar objective in relation to company directors. The Kay Review agreed that there is “*a need to clarify how these duties*

should be applied in the context of investment, given the widespread concerns about how these standards are interpreted”, but proposed that the matter be referred to the Law Commission. We support this course of action, provided that:

- the review is conducted in a timely manner, with steps taken to minimise any “chilling effect” on investor behaviour in the meantime (for instance, by reiterating and publicising the government’s view that the law does allow wider scope for discretion than is often assumed); and
- the Law Commission is empowered to recommend statutory clarification if it concludes that this is necessary, with a clear presumption in favour of speedy implementation of any legislative proposal.

13. In our experience, narrow interpretations of the law are reinforced by cautious legal advice, perpetuated by a lack of relevant case law, rather than simply being the result of trustee misunderstandings. We find it difficult to see how this problem will be resolved without express clarification of the law.

b. Clarifying the scope of fiduciary duties (Recommendation 7)

14. Kay also argues that short-termism is related to the replacement of relationships based on trust and confidence with a “transactional” trading-led culture, and that reasserting fiduciary standards will help to refocus equity markets on the long-term interests of savers rather than those of financial intermediaries. We agree that all those managing other people’s money should be held to fiduciary standards of care, and that—combined with action to address misinterpretations of fiduciary duty, as discussed above—this should help to promote long-termism.

The problem

15. Fiduciary duties exist to ensure that those acting on behalf of others keep their best interests at heart. Yet there remains some confusion about who fiduciary duties apply to. While it is clear that pension fund trustees are fiduciaries, the status of many others who look after savers’ money is less clear-cut:

- There appears to be a growing consensus that asset managers are subject to fiduciary duties: the Law Commission has concluded that “*in general a firm advising a customer or making purchases on a customer’s behalf will be acting in a fiduciary capacity.*”³⁶ However, this is still not undisputed, and asset managers often use the term “fiduciary” to describe a general duty of care towards clients rather than to indicate acceptance of the strict obligation to put beneficiaries’ interests first.
- Insurance companies (who are responsible for an increasing proportion of the nation’s pension savings) are generally held not to have fiduciary duties. This is largely because individuals saving with an insurance company are not the “beneficial owners” of the assets invested: instead the assets are owned by the insurance company, with the saver’s rights over them arising from their contract with that company. However, the economic relationship is essentially the same: one person is still entrusting their money to another for investment purposes.

16. It has been argued that debates about the extent of fiduciary duties are a legalistic irrelevance, since FSA rules (including those stemming from European regulations such as MiFID) already require investment intermediaries to act in the best interests of their clients. This is misleading. As the Law Commission has observed, “*there are many instances where regulatory rules permit... a lower standard of conduct than that required by fiduciary law.*”³⁷ For example, fiduciary duties require “*single-minded loyalty*” to beneficiaries,³⁸ while FSA rules merely require that firms pay “*due regard*” to the interests of their customers. Similarly, fiduciaries are required to avoid conflicts of interest wherever possible, and where impossible, to ensure that they are always resolved in the interests of the beneficiary. FSA rules require only that “*a firm must manage conflicts of interest fairly*”. Balancing the interests of consumers with the interests of the firm is a very different proposition from single-mindedly putting consumers’ interests first.

17. In our view, these legal differences do indeed have practical implications. There is considerable anecdotal evidence that conflicts of interest among fund managers are a barrier to more robust shareholder engagement. For example, one recent paper cites an instance where “*the company secretary of a UK manufacturer reminded a fund manager who was intending to vote against the company’s remuneration report that his firm was bidding for an investment mandate from the corporation’s pension plan.*”³⁹ In financial conglomerates, conflicts may also arise between asset management arms and investment banking arms.

18. When we surveyed asset managers’ disclosures under the Stewardship Code, we found that many gave little or no insight into how conflicts were managed.⁴⁰ To take a specific example, in the recent “Shareholder

³⁶ Law Commission, 1992, ‘Consultation Paper No. 124: Fiduciary Duties and Regulatory Rules’ (HMSO), para 2.47

³⁷ Law Commission, 1995, ‘*Fiduciary Duties and Regulatory Rules*’, (HMSO), para 1.8

³⁸ Bristol and West Building Society v Mothew [1996] 4 All ER 698

³⁹ Wong, S., ‘How conflicts of interest thwart institutional investor stewardship’, Butterworths Journal of International Banking and Financial Law, Sept 2011

⁴⁰ FairPensions, 2010, ‘Stewardship in the Spotlight’, p9, http://www.fairpensions.org.uk/sites/default/files/uploaded_files/whatwedo/StewardshipintheSpotlightReport.pdf

Spring”, both Aviva and Prudential suffered high profile rebellions on pay. Aviva Investors’ conflicts of interest policy sets out clear procedures for when and how it will vote shares in Aviva plc.⁴¹ M&G (the asset management arm of Prudential) has no such policy. In accordance with its policy, Aviva Investors did not vote on Aviva plc’s remuneration report unless in accordance with explicit instructions from clients. M&G voted in favour of Prudential’s controversial remuneration report; its voting disclosures provide no explanation of this decision or of how this conflict of interest was managed. The FRC and FSA⁴² have also identified conflicts as an area for improvement.

Response to the Kay Review’s proposed solution

19. The Kay Review recommended that “*regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions*”. Whilst accepting the thrust of Kay’s recommendation, the government’s response stated that it has “*elected to avoid using the word ‘fiduciary’*”, citing confusion over the scope of the term. In our view, the prevalence of conflicting assumptions about the scope of fiduciary obligation is precisely why this area of the law ought to be clarified.

20. However, even if the government chooses not to explicitly use the word “fiduciary”, the most important thing is that the standards of care which it promotes are equivalent to fiduciary standards. In our view, the wording of the government response creates—presumably unintentional—ambiguity on this front. The revised “good practice statement” does not explicitly assert the duty of undivided loyalty to clients/beneficiaries, stating only that “*conflicts of interest [should be] avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary.*” This would seem to imply that merely disclosing the existence of a conflict of interest is equivalent to managing that conflict in accordance with beneficiaries’ interests. In our view, this is not the case and does not tally with fiduciary standards.

21. We are very pleased that the government has asked the FSA/FCA to assess the extent to which its rules align with the “fiduciary-like” principles it has outlined. However, we are concerned that the wording of those principles must be clarified and refined, since the current wording obscures the very issue (ie conflicts of interest) where the difference between FSA rules and fiduciary duties is most significant. If this is not addressed, any FSA/FCA review could miss an important opportunity to meaningfully raise standards of consumer protection.

2. THE STEWARDSHIP CODE

22. The Kay Review recommends that “the Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance”. We agree that the Stewardship Code is an important vehicle for promoting investor long-termism, but have always regarded its principles as relevant to company strategy as well as corporate governance. Nonetheless, we believe there are other ways in which the Code could be improved, as outlined in our response to the FRC’s recent consultation.⁴³ Accordingly, although we accept the government’s view that this consultation has addressed Kay’s specific recommendation, we do not think that this should mark the end of policymakers’ engagement with the Code.

23. In particular, FairPensions has argued that the Code should:

- articulate more explicitly that engagement can and should extend beyond immediate financial matters and encompass drivers of a company’s long-term fundamental value, including environmental, social and governance (ESG) factors. This would help to address complaints from company directors that shareholder engagement is still short-term in nature and focussed too heavily on quarterly financial results;
- address more explicitly the role of institutional investors, particularly “universal owners” such as pension funds with holdings across the economy, in nurturing the wider economy and attending to potential systemic risks, rather than only engaging with risks to individual companies in their portfolio. Such systemic factors have far greater implications for returns to beneficiaries than the performance of any single company,⁴⁴ but this is not yet reflected in the way investors engage. The Stewardship Code could play a vital role in catalysing this cultural shift and overcoming the collective action problems which hold back engagement on systemic issues;
- be stronger and clearer in respect of conflicts of interest. As discussed above, our research finds this to be a consistent area of weakness amongst asset managers. The recent amendments to the Code, although welcome, do not seek to ensure that signatories explain how key conflicts of interest are managed in practice; and

⁴¹ http://www.avivainvestors.com/internet/groups/internet/documents/salessupportmaterial/pdf_024453.pdf

⁴² <http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf>

⁴³ See http://www.fairpensions.org.uk/sites/default/files/uploaded_files/StewardshipCodeReview2012.pdf

⁴⁴ See for example Brinson et al, 1991, “*Determinants of Portfolio Performance II: An Update*”, *Financial Analysts Journal* vol 47, no. 3 (May/June): 40–48; Ibbotson, “*The Importance of Asset Allocatio*”, *Financial Analysts Journal* Vol 66 No 2 (March/April 2010)

- articulate a clearer definition of “stewardship”. Although steps have been taken in the most recent version of the Code to address this ambiguity, the Code still does not define the term “stewardship” as such. In our experience, there is still confusion over what is being “stewarded” (companies, savers’ assets, or the economy and environment on which financial returns depend) and to whom stewardship obligations are owed (companies or savers).

24. We have also argued that the IMA’s annual survey is not the appropriate vehicle for official monitoring of the Code’s implementation, and that either the FRC itself or an independent academic institution should be resourced to undertake an independent annual survey. The FRC could also be required to report regularly to BIS on the Code’s implementation, with such reports being laid before parliament. In our experience, the Stewardship Code has so far been commendably successful at gaining the support of the investment industry, but it is far from clear that this support is translating into changed behaviour in practice. Effective, independent monitoring of whether progress is being made in this regard, made available to government and parliament, is an essential tool for policymakers to judge whether additional measures are needed.

25. Finally, policymakers must ensure that clients and beneficiaries are empowered to scrutinise the stewardship approaches of those who manage their money. This is essential if “comply or explain” is to be effective, since it relies on bottom-up scrutiny as a substitute for detailed top-down regulation. For example, instead of listed companies’ compliance with the Corporate Governance Code being enforced by regulators, it is overseen from below by shareholders (although the extent to which this actually takes place appears to be variable⁴⁵). The parallel audiences for disclosures under the Stewardship Code are clients and beneficiaries: pension funds in the case of asset managers, and underlying savers in the case of pension funds themselves. But structural problems hold back effective scrutiny:

- Pension funds have so far been less keen than asset managers to engage with the stewardship agenda, with many not seeing it as a priority, and some even believing (as we have seen) that it falls outside the scope of their legal mandate. Clarification of fiduciary duties should help to address this.
- Individual savers are disconnected and disempowered: lack of understanding and an endemic lack of transparency and accountability makes it difficult for them to engage with what happens to their money. Policymakers should take steps to improve public disclosure (for instance, of voting records) and strengthen beneficiaries’ rights to receive more detailed information on request.

3. THE INVESTOR FORUM

26. Collective engagement is vital given the increasing dispersion of ownership. In addition, effective collective action should enable investors to engage with wider systemic challenges affecting returns across their portfolio (such as climate change), as well as engaging on strategy at individual companies.

27. It remains to be seen whether the establishment of an “investor forum” as recommended by Kay will lead to a step change in this activity. At first sight it is unclear how this initiative will differ from previous and existing investor bodies, such as the Institutional Shareholders Committee (ISC).

28. Kay correctly identifies that misaligned incentives running through the system help to perpetuate short-termism. It is therefore somewhat surprising that his recommendations largely expect change to come from within that system (that is, through voluntary action from investment professionals, and asset managers in particular). In our view, it follows logically from Kay’s analysis of the problem that some kind of external force must act on the system in order to shift the incentives of its participants onto a more long-termist, sustainable footing. This would seem to be a prerequisite for effective industry action on the scale Kay wishes to see.

29. Such external action can come either from above (ie regulators) or below (ie clients and beneficiaries) or a combination of the two. However, experience suggests that at least one of these will be necessary: it will not be sufficient simply to expect the system to heal itself. Our recent report, *“The Missing Link: Lessons from the Shareholder Spring”*, provides further evidence of the disconnect between underlying savers and those who manage their money, and argues that policymakers should address this. Copies of this report have been provided to members of the Committee.

4. NARRATIVE REPORTING

30. Robust, meaningful company reporting on factors affecting the long-term value of a business—including environmental and social factors—is a prerequisite for effective investor engagement on these issues. The 2010 Coalition Agreement included a commitment to *“reinstate an Operating and Financial Review to ensure that directors’ social and environmental duties have to be covered in company reporting”*. This commitment originated in the Liberal Democrat Manifesto.

31. The key difference between the Operating and Financial Review (OFR) and the current Business Review was that the OFR required a higher standard of assurance (the “enhanced audit”). It was our understanding that

⁴⁵ See for example Arcot, Bruno & Grimaud, 2005, “Corporate Governance in the UK: Is the comply-or-explain approach working?”

the coalition commitment reflected this key difference and that its intent was to ensure that companies produced narrative information which investors could rely on. We strongly welcomed this commitment, since anecdotally we hear that one reason investors do not heed such information is that it lacks rigour and verifiability.

32. However, it soon became clear that (apparently as a result of the government’s policy of “one-in, one-out regulation”) there was little appetite for including enhanced audit standards in the new narrative reporting framework. Instead, the Business Review is to be replaced with a new “Strategic Report” whose status and prescribed content is almost identical to that of the Business Review, except for a renewed emphasis on strategy for quoted companies. This is to be supplemented with an “Annual Directors” Statement”, although it is unclear whether this will be prescribed by regulation, and if so what its content will be.

33. In our view this package of reforms to narrative reporting does not meet the spirit of the coalition commitment. It contains nothing which we would expect to drive up the quality of social and environmental reporting—the key objective of the original commitment. We are also sceptical of the contribution it will make to Professor Kay’s recommendation that “*high quality, succinct*” narrative reporting should be strongly encouraged—not least because it has little to say about what constitutes “high quality” reporting. We understand that the FRC will shortly be consulting on revised guidance for companies preparing narrative reports. This may provide an opportunity to rectify this disappointing outcome.

18 January 2013

**Supplementary written evidence submitted by ShareAction
(formerly FairPensions)**

Thank you very much for the opportunity to give oral evidence to the Committee’s inquiry on the Kay Review of UK Equity Markets. I am writing to clarify some aspects of our oral evidence, and to let you know of a change to FairPensions’ operating name.

Firstly, as of Monday 18 March, FairPensions will become ShareAction. This reflects the broader scope and relevance of our work to promote responsible and engaged share-ownership. It is also intended to clarify that our focus is on invested pension savings (and the investment system more generally) rather than on the state pension or on unfunded public sector schemes, as is often assumed. We have been in touch with Committee officials regarding the implications of this change in the event that we should be cited by name in the Committee’s final report.

As you are aware from our written and oral evidence, our two key areas of expertise and interest are fiduciary duty and accountability to underlying savers. The below is intended to summarise and clarify our position on these two issues.

FIDUCIARY DUTY

As you know, Professor Kay made two separate recommendations about fiduciary duty. The first concerned the question of *who* has fiduciary duties: Professor Kay recommended that these standards be extended to all those managing other people’s money. The second concerned the question of *what* these fiduciary duties mean, and in particular the need to clarify that they do not oblige institutional investors to focus solely on short-term share price movements: Professor Kay recommended that this be referred to the Law Commission.

The first of these two recommendations was well covered in the oral evidence session, but discussion of the second was somewhat truncated due to lack of time. We therefore thought it might be helpful to briefly restate our position, and in particular to clarify our perspective on the relationship between directors’ duties under the Companies Act and our proposed clarification of investors’ duties.

Section 172 of the Companies Act 2006 was designed to correct the widely held misconception that directors’ duty to act in shareholders’ interests prevented them from taking a long-term view and from considering their social and environmental impacts. It clarified that directors should “have regard” to these wider factors as part of their duty to promote the success of the company. This exactly mirrors the problem with interpretations of investors’ duties which we and Professor Kay have highlighted: there is a widely held view that institutional investors’ duty to act in the interests of underlying savers prevents them from taking a long-term, enlightened approach to the companies in which they invest.

Our argument is that these two problems are intrinsically connected. The Companies Act sought to achieve long-term, responsible corporate behaviour by promoting “enlightened shareholder value” (rather than by extending rights to other stakeholders in the company). But this job remains unfinished as long as major shareholders continue to believe that they themselves are legally obliged to be unenlightened.

This may help to explain the seemingly limited impact of the changes to directors’ duties under section 172.⁴⁶ Surveys suggest that directors continue to feel they have limited room for manoeuvre, particularly in hostile takeover situations, where it is assumed that the directors’ duty to get the best price for shareholders

⁴⁶ See for example Collison et al, 2011, “Shareholder Primacy in UK Corporate Law: An Analysis of the Rationale and Evidence”, ACCA

“trumps” section 172. If major shareholders interpret their own duties in terms of the maximisation of short-term return, it is hardly surprising that this imperative will be transmitted up the chain to directors. This fits with the evidence (both anecdotal and empirical) from directors about why they make the decisions they do.⁴⁷

It is for this reason that we believe explicit clarification of investors’ fiduciary duties, mirroring the clarification of directors’ duties offered by section 172 of the Companies Act, is an important part of the solution to short-term pressures on companies. We very much hope that this will be the outcome of the Law Commission’s review.

The above is elaborated in our 2012 report “The Enlightened Shareholder”, a copy of which is enclosed. We would be pleased to provide additional copies to the Committee if necessary.

TRANSPARENCY AND ACCOUNTABILITY

As you know, we believe that in order to make Professor Kay’s vision for equity markets a reality, it will be necessary to strengthen the connection between savers and their money, by enhancing transparency and accountability of the investment industry to its customers. In our view, insufficient thought has been given to this by policymakers, who have tended to focus instead on the connection between companies and institutional investors. We have recently embarked on a research project aimed at rectifying this imbalance, which will be reporting with policy recommendations in the summer. Meanwhile, mindful of your request for specific proposals, we thought it might be helpful to summarise our key suggestions to date.

- Pension funds should be obliged to report to their beneficiaries not just on their investment and voting policies (as now), but also on how those policies have been implemented on an annual basis. This could take the form of a “narrative report” along similar lines to the reports which companies are obliged to produce for their shareholders.
- Government should exercise its reserve power to introduce mandatory voting disclosure for institutional investors. Please see below for more detail on the case for this measure.
- Institutional investors could be obliged to hold annual meetings (in the same way that companies must hold annual meetings for their shareholders) offering savers the opportunity to hold their fiduciaries to account.
- Government could explore ways to support and strengthen the role of member-nominated trustees, and to extend similar member representation to contract-based forms of pension provision. We could also learn from the approach taken in other jurisdictions, for example Denmark’s system of “member delegates”, which provides an additional level of scrutiny between the pension fund and the membership at large.

The case for mandatory voting disclosure

Disclosure of information about voting and engagement allows underlying savers to hold their agents to account for the exercise of shareholder rights on their behalf. ShareAction (FairPensions) works to build such a culture of accountability, and at present we find that lack of transparency is a fundamental barrier to its development. Individuals who contact their pension funds to ask how votes were cast at a particular company or on a particular issue are often given no information or simply told that the decision is delegated to asset managers.

We recently conducted an analysis of responses to saver emails about voting intentions on executive pay, sent via an email tool we built in April 2012. Less than half of responses stated that the fund disclosed their voting records, and only around one in five provided direct links to such disclosures.⁴⁸ This is a disheartening experience for savers who are therefore less likely to continue attempting to engage with decisions about their money. Improved transparency has the potential to transform this “vicious circle” into a “virtuous circle” of greater engagement and accountability.

Our benchmarking surveys of institutional investors consistently find a link between transparency and substance: in other words, investors who disclose good information about their policies and practices tend to perform better in our analyses of the quality of their policies and their evidence of commitment to stewardship.

Voluntary mechanisms (such as the Stewardship Code) have generated improvements in voting disclosure, but evidence suggests that these improvements are beginning to plateau, at a level still far below universal disclosure. Although the IMA suggests that around three-quarters of Code signatories now disclose some voting information, this figure includes summary statistics (ie the total number of votes cast for and against management in a given year) which we would not regard as meaningful voting disclosure. Research by PIRC suggests that, even among Stewardship Code signatories, the proportion disclosing full information about individual votes cast is in fact just 21%.⁴⁹ This reinforces the case for mandatory requirements which clearly set out the information to be provided in order to ensure that it is comprehensive and comparable.

⁴⁷ See for example Graham et al, 2004, “The Economic Implications of Corporate Financial Reporting” (in a US context)

⁴⁸ FairPensions, 2012, “The Missing Link”

⁴⁹ See <http://www.pirc.co.uk/news/voting-disclosure-revisited>

Practical arguments sometimes made against mandatory public disclosure of voting include:

- that it would impose an unreasonable cost on investors;
- that it would breach commercial confidentiality; and
- that it would be pointless as there is no demand for this information.

In our view these arguments have little merit:

- The vast majority of UK investors already record data about their voting behaviour. The cost of disclosure is simply a matter of formatting this data and uploading it to a public website. Evidence from investors who already do this suggests that these costs are minimal.
- We see no reason why voting information should be commercially sensitive. The fact that many investors disclose their voting records (usually quarterly in arrears) suggests that these concerns are unfounded.
- As indicated above, the opacity of the investment system is itself a key barrier to the development of demand for this information. In any case, the information will be used by academics and civil society organisations (such as ourselves) to compare investors against each other in a more consumer-friendly format. Finally, the knowledge that voting decisions are subject to public scrutiny may in itself help to shift behaviour.

Catherine Howarth

Chief Executive, ShareAction (formerly FairPensions)

14 March 2013

Written evidence submitted by the Association of General Counsel and Company Secretaries of the FTSE 100 (GC100)

This submission is on behalf of the Association of General Counsel and Company Secretaries in the FTSE 100, generally known as the GC100. There are currently 131 members of the group, representing more than 82 companies.

The GC100 is grateful for the opportunity to respond to the call for evidence referred to above. Our response on the matters on which you are seeking views is set out below. Please note, as a matter of formality, that the views expressed in this letter do not necessarily reflect those of each and every individual member of the GC100 or their employing companies.

1. Executive Summary

We broadly support the Kay Review and the Government's response as an overarching framework of aspirations for how the UK equity markets should operate. Likewise, we believe that the general principles are, in the main, useful high level statements of best practice. The key challenge will be how these concepts are understood and implemented within the complex legal and regulatory matrices in which the UK equity markets operate. This will require careful and detailed examination and discussion.

In addition to the domestic framework, the UK equity markets are subject to regulation at the European and international level. This is particularly the case for the significant number of companies with dual or multiple listings. These, and many other UK companies whose only listing is in London, have businesses and teams located in and/or recruited from other jurisdictions. Their businesses and management (including board) recruitment and retention arrangements are therefore structured and run to reflect both UK and international demands. Furthermore, the importance of international investment in London-listed companies means that the UK market is inextricably linked to the commercial and governance requirements and expectations of market participants in other jurisdictions. Although we believe that many of the recommendations in the Kay Review and the Government's response are commendable, it is imperative that any specific proposals flowing from the Kay Review be formulated and implemented in this context.

In particular, care needs to be taken to ensure that UK companies:

- are able to compete effectively with their peers in other jurisdictions;
- are not subject to requirements which deter international investment; and
- can recruit and retain the best management teams, including directors, for their companies and businesses.

2. DETAILED SUBMISSION

2.1 *Directions for Market Participants—paragraph 3*

Paragraph 3 of the Directions for Market Participants recommends that there should be more opportunity for collective action by asset managers who should have more freedom to act collectively without fear of regulatory consequences. We agree with this, and in particular, the need for people to be able to collaborate without fear of being deemed to be acting in concert under the UK Takeover Code. However, we believe that the Takeover

Code, as interpreted in light of Practice Statement 26, already confers on asset managers the necessary freedom to take collective action and that they do not need any greater regulatory exemptions or dispensations to facilitate this.

2.2 Recommendation 1: The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.

We support this Recommendation and believe that discussion and debate on remuneration and other governance issues is far more productive when placed in the context of a company's long-term strategy rather than, as so often appears to be the case, being conducted in isolation. Some of our members have reported that where a broader view is taken, for example, where fund managers and corporate governance or remuneration analysts are both represented at the same meetings, this can be more productive than meetings which are attended only by those responsible for corporate governance.

2.3 Recommendation 2: Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements.

We support this Recommendation in principle.

Please also see our specific comments on Annex A—Good Practice Statement for Directors, at paragraph 2.14 below.

2.4 Recommendation 3: An investors' forum should be established to facilitate collective engagement by investors in UK companies.

We would express a cautious interest in the concept of investors' forums. There is, of course, nothing to prevent interested parties from establishing such forums now, which leads us to question whether there is really a need for this type of body—if there is, would they not already be widely in existence?

If investors felt that such a body would help them to engage more effectively with investee companies, then we think that this proposal should be pursued but a number of aspects would warrant further development as noted below.

We assume that the plan would be for a specific forum to be created for an individual company, as we do not think that it would be workable for a forum to cover multiple companies. The success of such a forum would depend on its having well defined parameters (objectives, attendees, frequency etc), yet retaining the flexibility to meet the circumstances of individual companies. For such a forum to add value there would need to be a commitment to candid discussion.

The composition of the forum would be very important. Whilst the idea is termed an "investors' forum" we would not wish such forums to comprise solely of investors who set the agenda and provide the company with their views. It would have to be a collaborative exercise with the company being properly represented and conduct of the meeting being effectively regulated. We would also be interested in understanding more about the criteria that would be recommended to ascertain which investors could attend—would it, for example, be based on a qualifying percentage of share ownership or open to any shareholder? How would significant shareholders based overseas be encouraged to participate? It will be key to ensure that the eligibility criteria for participation in the forum (and any guidelines as to how the forum operates) are such that stability and consistency are promoted. For engagement to be meaningful over the longer-term, the forum will need to be consistent in its approach and focus even if there are changes in the company's investor base. A framework that encourages the represented shareholders to provide an indication of their voting intentions on specific matters would be helpful for companies and increase genuine engagement.

Greater clarity about the intended purpose of the investor forum would be welcome. If the intention is to foster longer-term engagement between the forum and the company, we believe that it would be preferable for a forum to meet with the company on a regular, perhaps annual, basis, rather than convening meetings in response to particular events or crises. This latter approach would not foster continuity and may adversely impact on management's ability to manage such events successfully. We would not, in any event, wish to see such meetings having to be scheduled too often, as there will be an associated cost as well as time and administration involved in convening and attending them, both for the company and investors. We also consider that there must be doubts as to the practicalities of events-driven meetings because of the difficulties there would be in setting the criteria to establish when a relevant event has occurred and ascertaining when such criteria are met so as to require a meeting. There may also be difficulty in arranging meetings on short notice to canvas views on events which are of an urgent nature. It is also not wholly clear whether the forum would be intended to replace or be in addition to the frequent and regular meetings which many companies' senior executives typically already have with fund managers and others at major institutional shareholders as part of companies' regular "investor roadshows" in the weeks following results announcements.

The agenda for any such forum would have to be carefully considered and, in particular, it would have to take account of the difficulties around disclosing confidential and/or inside information. This may also hinder the practicality of holding meetings in response to certain events rather than as regular fixtures.

Furthermore, it is important from the point of view of shareholder democracy that engagement with such forums is not seen as a substitute for putting matters to shareholders generally and that these proposals do not result in a conflict with Principle 5 of the UKLA Listing Rules which requires a listed company to ensure that it treats all holders of the same class of listed equity securities that are in the same position equally. As a related point and, as highlighted above, the composition of a forum would require careful consideration to avoid the consequence of concentrating influence in a small number of represented shareholders.

2.5 Recommendation 4: The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves.

We are not sure what is meant by the comments at paragraph 3.26 of the Government's response, and, in particular, the point that "the Government believes it would be appropriate for government to take a greater interest in mergers and acquisitions". We also consider that reference in the Kay review to the Government and regulatory authorities using "informal authority" to be particularly unhelpful. We believe that all parties should be able to rely on a clear and transparent set of rules without having to be concerned about possible Government intervention based on evanescent political considerations which happen to be relevant at the time.

We believe that it is right that the Government should impose rules and regulations to regulate properly the conduct of mergers and acquisitions, but we believe that the current provisions of the Takeover Code as enforced and interpreted by the Takeover Panel, together with the merger control regime, do this job very well.

2.6 Recommendation 5: Companies should consult their major long-term investors over major board appointments.

Unlike the other recommendations, this seems to be a very specific new requirement and we would welcome greater clarity on what might be proposed. For instance, it is not apparent to us what the Government would regard as major board appointments for this purpose. The Kay Report envisages that the chairman and "important non-executive appointments" would fall within this category. However, "major board appointments" could include executive director appointments.

Information about individual appointments, particularly for senior or executive directors, may constitute price-sensitive information about a company. The disclosure (or delay in disclosure) and the dissemination of such information is therefore subject to significant regulatory constraints (for example, pursuant to DTR 2). If the information is considered to be inside information, the investor would need to be wall-crossed prior to any discussions. This may be problematic as, in our experience, institutional investors are unlikely to agree to this if discussions are continuing for any period of weeks, as they would be prevented from dealing for a prolonged period of time. In addition, consulting with a number of investors may also increase the risk of a leak, even if confidentiality arrangements are imposed. We note that it is suggested that an investor forum may be an appropriate venue for these discussions. For the reasons set out previously, we doubt whether this is workable in practice.

As a more general point, confidentiality is vital for prospective board appointments, not only from the company's perspective but also, in many cases, for the candidate and for any other company of which the candidate is already a director. We think that there would be a risk that sensitive negotiations could be jeopardised if the company had to share information with investors before or during the process.

The existing legal and corporate governance framework applicable to UK companies already provides shareholders with significant influence over board appointments and it is not clear to us what "consultation" means in this context.

In addition, there may be circumstances where a requirement to consult shareholders could undermine a board's ability to act in the best interests of shareholders as a whole—for example, where a board is seeking to appoint a new independent non-executive director in order to bolster the independence of a board in the face of a significant or founding shareholder with its own agenda, the requirement to consult might lead the shareholder to take action to frustrate the board's choice of independent director. Rules requiring consultation would in our view run the risk of being too prescriptive and interfering with the board's ability to act in the interests of all shareholders.

We would welcome more specificity on the proposals, in particular, as to the level and nature of discussions envisaged by this recommendation.

In conclusion, we do not believe that this recommendation would work in relation to the proposed appointment of individuals to specific posts. We do, however, think that there would be merit in there being dialogue between companies and investors, as there currently often is, regarding the general composition of the board, succession planning, and whether there is a need for additional skills or experience to be represented.

2.7 Recommendation 6: *Companies should seek to disengage from the process of managing short-term earnings expectations and announcements.*

Whilst we welcome Recommendation 6 and, in particular, the changes that will see an end to the mandatory requirement for UK companies to produce quarterly reports, we believe it is important to note that for many international companies the position is not necessarily that simple. For UK companies with international businesses, notably those with operations or listings in the US, there may still be a legal or regulatory requirement to report more frequently and/or in a way that engenders a short-term view. Even in the absence of a formal requirement, where UK companies have a sizeable international investor base, there may be an expectation on the part of non-UK investors of more frequent reporting than may be required in the UK. While changes to EU or UK laws and regulations are, therefore, to be welcomed, it may be that for many companies, the changes will not alleviate the situation and/or lead to the shift in focus that is desired.

We also believe that to give real effect to this proposal changes in UK/EU regulation may be required. At present, UK listed companies are under obligations to disclose inside information to the market as soon as possible. This means that any information which may have a significant impact on share price (however short-term) has to be disclosed and, indeed, recent pronouncements by the FSA appear to demonstrate the FSA's belief that disclosure (under DTR 2) is required in respect of any information which may be relevant to a reasonable investor, even where this would not be likely to be price-sensitive, though others argue that this is an incorrect interpretation of FSMA. So the Disclosure and Transparency Rules are themselves straight-jacketing companies into announcing short-term information and, in our view, this is bound to lead to companies seeking to manage short-term expectations. Therefore, whilst we consider the Kay review proposals for companies to focus on the long-term rather than to expend energy about managing short-term expectations to be laudable, we have doubts about the ability to effect changes in this connection without a change in the Disclosure and Transparency Rules, which themselves reflect EU law.

2.8 Recommendation 11: *Mandatory IMS (quarterly reporting) obligations should be removed.*

See our comments on Recommendation 6 above.

2.9 Recommendation 12: *High quality, succinct narrative reporting should be strongly encouraged.*

We endorse this recommendation. However, in order to ensure its success, we believe it will be important to ensure that there is a “joined-up” approach between all legislative and regulatory bodies as, although in the UK there is an attempt to “de-clutter” annual reports, this principle needs to be consistently applied.

As noted in paragraph 2.8 above, we would also note that for UK companies with international investors and/or operations there may still be a strong expectation, if not actual legal or regulatory requirements, for more discursive reporting. In this respect, we particularly feel that it would be useful for the Government to liaise with the US Securities and Exchange Commission (SEC) in relation to the level of reporting that is required for SEC registered UK companies. If not, any streamlining of the UK position would be undermined by US regulation which, generally, requires more detailed reporting.

2.10 Recommendation 14: *Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment.*

We endorse this recommendation. However, we would again make the point set out in paragraphs 2.8 and 2.9, that the international nature of many UK companies may mean that such companies may still be required, or be expected, to comply with regimes which do prescribe specific models.

2.11 Recommendation 15: *Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business.*

We support the principle set out in the first sentence. We do not agree with the principle in the second sentence for the following reasons;

- in any remuneration structure it is important to preserve an element of flexibility. Different businesses operate in different ways and the nature of their operations can mean that different reward structures suit different businesses. Any changes to the executive remuneration regime need to preserve such an element of flexibility. For companies whose business model and cycles make it appropriate to structure compensation in this way, then they can already do so. But it is unlikely that there can be a “one size fits all” type of policy;
- such a policy is likely to make it considerably harder to attract good candidates. This is likely to be a particular issue for the many London-listed companies' which have some or all of their operations and/or directors located outside the UK in jurisdictions where there is no equivalent policy. In such circumstances, exporting such a UK standard could make it very difficult to attract and retain talent;

- in many cases, performance related pay has become a significant part of the remuneration package relative to basic pay. In these cases, directors will have come to rely on the performance related pay and deferral for the length of time envisaged by the Recommendation may be impractical;
- such a policy may simply shift the emphasis from performance related pay to basic pay (see the point above) which could possibly mean that there is less incentive for management to pursue performance enhancing strategies; and
- such a policy may also be counter-productive, and encourage the early resignation of successful executives (to trigger release of their long-term incentive gains), leading to an increased ‘churn’ of executives, and thereby reducing the long-term strategic focus that is being sought by implementing such a policy.

If it is concluded that an obligation to hold shares in the longer-term is required, we wonder if there may be better ways to achieve this. For example, many companies already have a requirement for executive directors to hold a significant number of shares in the company (for example, calculated by reference to a percentage of their base salary). Many companies are also introducing longer vesting periods. We believe these approaches are already being more effectively used to achieve the same objective.

2.12 Recommendation 16: *Asset management firms should similarly structure managers’ remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund.*

Whilst we do not consider that this recommendation is directly relevant to the GC100, many of our members have pension schemes which rely on the performance of asset managers to enhance the returns to their employees and pensioners and, therefore, have an interest in this recommendation. We, therefore, support the recommendation in principle and, in particular, the notion that it is long-term performance which should be incentivised and rewarded, although again we do not believe that it is necessarily the case that a fund manager should be required to retain his entire interest in the fund for the whole of his period of employment or responsibility for the fund, as opposed to a specified minimum level of interest.

2.13 Recommendation 17: *The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.*

We agree with the need to address this recommendation in the context of policy proposals relating to central securities depositories and securities law in the EU. We also think that it is necessary for any system to be able to cater to the wishes of shareholders—whilst some may wish to hold shares directly on an electronic register and take direct advantage of the rights and obligations of being a shareholder, there will be those who wish to hold shares through a nominee because they are happy to forego such direct involvement.

The cost and administrative burden for companies in moving to any new system and, in particular, where paper based shareholders have to be moved to any such system, need be borne in mind. It will be necessary to weigh up such factors with the benefits to be gained. We believe that there will, in any event, be a natural shift towards more technology driven systems and that companies will move in that direction at a time that best suits them. We doubt if it is worth obliging companies to adopt new systems which may mean they have to do so at a time which does not best suit their individual circumstances.

2.14 Annex A—*Good Practice Statement for Company Directors*

(a.) Paragraph 1

The law relating to directors’ duties has been codified in the Companies Act 2006 which sets out the factors which directors should consider in determining whether a decision will promote the success of the company. We believe that these provisions deal with the position adequately and consider that it would be unhelpful to include factors which overlap with the statutory factors but omit some and add others.

(b.) Paragraph 2

Whilst we acknowledge that this principle may be correct for many companies, we believe that it may not suit all companies. Each company will have to act in the way that best suits its own business and strategies. There are, of course, companies whose business *is* the management of a portfolio of financial interests.

(c.) Paragraph 3

Whilst we consider this point to be desirable, we believe that it is largely outside the control of directors—intermediation costs are set and controlled by third parties over whom directors have little or no control.

(d.) Paragraphs 4, 5, 6 and 7

We support the principles underlying these paragraphs as we can see that they are consistent with the objective of promoting a long-term focus. We do, however, consider that there are laws and regulations which, if not amended, may hinder the achievement of such a focus and perpetuate a more short-term approach.

Companies in the UK have traditionally been more reluctant than in other markets to provide clear financial guidance on longer term prospects. We perceive that this is an ingrained cultural approach, which we believe may have its roots in, or at least is reinforced by, two aspects of the regulatory regime within which listed companies operate:

- the rules on profit forecasts (both under the Prospectus Rules and the Takeover Code) discourage companies from producing explicit forecasts, at least for the near term—listed companies are materially constrained in their willingness to provide meaningful forward-looking financial information because profit forecasts published as part of regular reporting may require to be repeated (in circumstances where the directors face personal liability without the benefit of the protections provided by section 463 of the Companies Act 2006) and reported on by independent accountants;

the way the continuous disclosure obligations (for listed companies, under Chapter 2 of the Disclosure and Transparency Rules, implementing Article 6 of the Market Abuse Directive) are interpreted and enforced by the FSA tends to mean that if a company has provided financial guidance on its longer term prospects but there is a change in circumstances that makes achievement of that guidance more challenging it will be required to make early disclosure of that by issuing a profit warning. Generally, markets react adversely to such disclosures and companies may be reluctant to give guidance in order to reduce the risk of having to issue profit warnings.

If it is desirable to encourage UK companies to provide more specific forward-looking information, we think the rules require a major overhaul with a view to creating a climate in which efforts made in good faith by management to identify longer-term financial prospects are not perceived to expose the company concerned, and its management, to unacceptable regulatory risks. It may not be easy to achieve a balance between, on the one hand, the requirements of investor protection (given the risks associated with forward-looking statements that are inevitably to some extent speculative) and keeping the markets informed and, on the other hand, the need to facilitate better long term disclosure, but we think the effort should be made.

An appropriate safe-harbour regime that encourages companies to provide clear guidance on their financial prospects together with the companies' assumptions regarding external factors and risks that may prevent their achievement would provide a sounder basis for a focus on longer term performance.

(e.) Paragraph 10

Please see our comments on Recommendation 15 at paragraph 2.12 above.

(f.) Paragraph 11

Please see our comments on Recommendation 5 at paragraph 2.7 above.

(g.) Paragraph 12

Please see our comments on Recommendations 6 and 11 at paragraphs 2.8 and 2.9 above.

18 January 2013

Written evidence from BT Pension Scheme Management Ltd (BTPSM), Universities Superannuation Scheme (USS) Limited and Railpen Investments (RPMI)

As three of the UK's largest defined-benefit pension schemes, BTPS, USS and Railpen we welcome the direction of Professor Kay's final analysis and subsequent support by the UK government. By way of background our full submissions to the Kay Review's interim and final reports can be found on the BIS website.

While the Kay Review successfully analysed the problems which arise from short-termism, we believe further action is required to address some of the major structural causes.

One key area we believe requires focus is the role of pension funds/asset holders. For example, we believe that pension funds must play a central role in the governance and operation of any investor body charged with a stewardship role for all investors. This is because pension funds in general are less conflicted than asset managers and tend to collaborate more readily. In addition, pension funds have longer term investment strategies as our liabilities or commitments may stretch into decades.

Please find attached a copy of a joint letter we wrote to Professor Kay ahead of his final report which we would like to submit as evidence to the Committee. We would welcome a meeting with the Committee to discuss these issues in more detail.

ANNEX

COPY LETTER FROM BT PENSION SCHEME MANAGEMENT LTD, UNIVERSITIES
SUPERANNUATION SCHEME (USS) LIMITED AND RAILPEN INVESTMENTS (RPMI) TO
PROFESSOR JOHN KAY DATED 3 JULY 2012

Dear Professor Kay,

Thank you for taking the time to meet with us on 21 June. We hope you found the discussion as helpful as we did.

As you write your final report and recommendations we thought it might be helpful to reinforce some of the key points we have already made in our respective submissions to you.

As you know, we support your key objectives to introduce measures which could shorten the investment chain and better align interests across the chain to the long-term interests of pensioners. We welcome your analysis that there is a problem of excessive intermediation.

We would encourage you not only to analyse the consequences of the way intermediaries behave but also to address some of the major structural causes of their short-termism. To prevent further divestment by the UK's pension funds from the UK's equity markets we would encourage you to consider two recommendations:

- More scale in the pension fund industry should be encouraged to help owners better control their costs and their agents and reduce the need for intermediation. This is a particular problem in the defined contribution world, which is becoming in effect owned by the fund management community; aggregated vehicles with independent governance are likely to serve beneficiaries' interests better.
- Focus pension fund regulation and accounting on the long-term. The Pensions Regulator should allow for greater smoothing on the valuation of assets and liabilities, and the proposed Solvency II type capital requirements for pension schemes should be abandoned or delayed.⁵⁰ These changes are vital for allowing pension schemes to themselves incentivise asset managers (internal and external) for the long term.

As three of the UK's largest defined-benefit pension schemes, we have long recognised that stewardship is critical in protecting and enhancing the long term value of investments. While we recognise the need to link stewardship activities to investment decision-making, we do not believe that—given current incentive frameworks—it is in most asset managers' interests to undertake effective stewardship activities aligned to the interests of our beneficiaries. It is for these reasons that we believe oversight for stewardship must rest firmly with the pension scheme Trustees and executives. We also recommend that your proposed institutional investor body includes organisations that are closer to the ultimate beneficiaries to ensure their long term interests are properly represented.

It would also be helpful if your report recognises that there are likely to be different solutions to the agreed problems. For example, we have each adopted different models, none of which, it is worth noting, involves outsourcing stewardship functions to external investment managers. USS has adopted a largely in-house investment management and stewardship function. Railpen's investment management function is entirely outsourced with stewardship led internally with a partial outsourcing to a specialist provider. BTPS' investment management is outsourced and stewardship is undertaken by Hermes Equity Ownership Services (EOS) which sits within the asset manager BTPS owns.

For the smaller UK pension schemes who decide to delegate their responsibility for stewardship, we would recommend efforts should be made to form collaborations between asset owners similar to the voting alliance between USS and Railpen, and the collaborative alliance of over twenty investors under Hermes EOS. There may be other viable solutions, and we would welcome our peers working to develop these.

We welcome your analysis of the problems we face in confronting excessive intermediation in the investment chain. There are short-term vested interests, as well as poorly-aligned incentive frameworks that need to be addressed. We would welcome recommendations that could help asset owners assert their authority and ensure they are able to act for their own long term interests including 1) tools to permit asset owners to achieve scale in negotiations with agents over costs as well as in stewardship activities, and 2) reforms to the pension fund accounting and regulatory framework that encourage long term investing. A bolstering of the FRC's Stewardship Code, and particularly the role of asset owners as part of it, could also be an important element of aligning asset managers with owners' long term interests.

Yours sincerely

Natasha Landell-Mills
Universities Superannuation Scheme (USS) Ltd
Frank Curtiss
RPMI Railpen Investments

⁵⁰ See OECD discussion note, Promoting long-term investment by institutional investors. Please also see point 3 in the submission by institutional investors "Proposals to tackle problems with IFRS—submission to the Kay review", 25 June 2012.

Helene Winch
BT Pension Scheme Management Ltd

Written evidence submitted by The National Association of Pension Funds Limited

1. INTRODUCTION

1.1. The NAPF is the leading voice of workplace pensions in the UK. We speak for 1,300 pension schemes with some 16 million members and assets of around £900 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

1.2. We welcome the Committee's undertaking of this inquiry into the Kay Review of UK Equity Markets and Long-Term Decision Making. This is an important issue and one which is of considerable interest to our members; in the case of DB pension funds, their interest in a successful UK corporate sector extends beyond that of an equity investor to that of an unsecured creditor, by virtue of the sponsor backing of private sector schemes.

1.3. The NAPF warmly welcomed the government's launch of the Kay review as well as the government's response to Professor Kay's report, both of which we gladly hosted.

1.4. The NAPF believes that equity markets must work more effectively in the long-term interests of investors and savers, who need to be able to see that they are getting value for money. The analysis presented by professor Kay and which was endorsed by the Secretary of State for Business, Innovation and Skills, Vince Cable MP, was sound and rightly highlighted the range of challenges that need addressing.

1.5. In its response, the Government acknowledged that there had been broad acceptance of Professor Kay's analysis, though this was accompanied by some scepticism about whether change is achievable, and whether the Government, UK companies and the investment industry can bring it about.

1.6. While many of the issues we identified in our submission to the Kay review were addressed in varying degrees in the final report, we were disappointed that some of the positive discussion in Professor Kay's interim report failed to make its way into any of the recommendations within the final report. While to a very large extent the NAPF endorses Kay's conclusion that the chain of intermediaries in the investment process is too large and costly, we were underwhelmed with the proposed solution to address this which largely boiled down to: leave it to the market.

1.7. However, by endorsing Professor Kay's recommendations, the Government is giving a clear direction of travel, which will help pension funds play their part in reducing a short-term culture in UK companies and markets—the NAPF will endeavour to play its part in achieving this.

2. A REGULATORY ENVIRONMENT WHICH SUPPORTS LONGER TERM RISK-TAKING BY PENSION FUND INVESTORS

2.1. In recent years pension regulation has driven funds and their sponsors increasingly to take a shorter term view. The NAPF has written at length and commissioned research⁵¹ on IAS 19 which we see as driving sponsors to place excessive emphasis on accounting measures of solvency. Likewise the Pensions Regulator's guidance on recovery plans encourages schemes to reach full funding over quite short time horizons. In addition, the European Commission's moves to introduce a solvency test akin to that applied to insurance companies threatens still further to force more schemes to close to future accruals.

2.2. More generally, our members have had to deal with a regulatory environment which has been in constant flux for much of the past fifteen years or more. While most of these changes do not deal directly with investment matters there has all too often been a knock-on consequence for funds' investment policies which was not considered when evaluating the merits of new regulations.

2.3. Professor Kay acknowledges the above in his report and rightly states that regulation should focus on the establishment of market structures which provide appropriate incentives. Kay also rightly states that the possible extension of Solvency II principles to pension funds is a matter of particular concern—indeed we believe that the introduction of a Solvency II-style approach to pension scheme funding, represents the single biggest threat to UK defined benefit pension schemes and would equate to a *£291 billion* increase in scheme funding requirements. If sponsoring employers were required to put more funds into their pension schemes, then there would be less money available for investment and innovation, with a concomitant impact on growth.

3. GREATER TRANSPARENCY AROUND INVESTMENT FEES AND CHARGES

3.1. In our submission to the Kay review we indicated that there is a need for the asset management industry to improve its disclosure of charges, costs and remuneration structures in the light of the likely growth of the industry, following the introduction of auto-enrolment to pension funds from 2012.

⁵¹ Accounting for pensions, Leeds University Business School, 2011

3.2. This was an issue which Professor Kay picked up upon in his report and around which there was a particular focus by many last year. Pleasingly there has resultantly been a significant amount of progress. This includes a new joint industry Code of Conduct⁵² for disclosing information to employers on the charges made on workplace pensions. This Code should enable, for the first time, the consistent disclosure of charges and investment costs across the workplace pensions landscape.

4. FOSTERING GOOD PRACTICE

4.1. The Government agrees that “asset holders” have a key role to play in setting the incentives on asset managers, and believes a shift in behaviour in this area will be vital for fostering long-term engagement between asset managers and company directors. To achieve this behavioural change, it was suggested that the Stewardship Code should continue to develop its definition of Stewardship and a number of Good Practice Statements should be adopted by relevant parties.

4.2. Members of the NAPF have a clear interest in promoting the long term success of the companies in which they invest. For this reason we have since its launch in 2010 been a strong supporter of the UK Stewardship Code. We also fully support the recent revisions to the Code which were introduced in September 2012 and which we, like the government, believe have appropriately continued to develop the understanding of “stewardship”.

4.3. While the Stewardship Code in its first iteration was understandably focused towards asset managers, we are pleased to note that pension funds have themselves been embracing their stewardship responsibilities, the recent revisions to the Code which further clarify the responsibilities of asset owners and managers will further help.

4.4. In December 2012, the NAPF published its eighth annual survey of pension funds’ engagement with investee companies.⁵³ The results from this survey which included members with combined assets under management of £323 billion demonstrated that pension funds are beginning to foster a market for stewardship. The survey indicated that:

- 93% of respondents agreed that institutional investors (including pension funds) have stewardship responsibilities which include engaging with companies and voting.
- 71% of respondents had taken the stewardship activities and policies of asset managers into account when selecting them.
- An overwhelming majority (90%) of respondents had reviewed their asset managers’ application of the stewardship policy.
- 93% of respondents had exercised their votes in the UK (up from 90% in 2011) and there was a similar trend in other jurisdictions.

4.5. One of the issues our 2012 Engagement Survey flagged up was that the same level of progress is not necessarily being made by others in the investment chain, particularly among investment consultants.

4.6. Our survey indicated that investment consultants proactively raised the issue of stewardship with pension funds in only two out five cases (38%). In addition, when it was discussed, investment consultants recommended signing up to the Code in less than half of cases. As key intermediaries between pension funds and asset managers, investment consultants could do more to encourage the take-up of the Code by explaining its relevance to their pension fund clients. We believe that this could help drive more pension funds to sign up to the Code.

4.7. As indicated above, since its launch a significant number of pension funds have signed up to the Stewardship Code. However, in light of the recent revisions to the Code and increasing focus on the issue we do believe that the time is right for pension funds to review their approach to Stewardship, question whether it could be more effective and consider how they should undertake their Stewardship requirements.

4.8. For this reason, alongside the Government’s response to the Kay Report, the NAPF published its first ever Stewardship Policy⁵⁴ which aims to help pension funds understand and fulfil their responsibilities as investors and to become signatories to the Stewardship Code. As the results of our 2012 Engagement Survey demonstrate, many pension funds are already embracing their responsibilities in this area and we are encouraging and assisting others to do likewise.

4.9. We also support the Good Practice Statements proposed by the Kay Review and endorsed by the government. The NAPF Stewardship Policy includes a number of principles for stewardship best practice, closely reflecting the direction set out in this area by Professor Kay in his Good Practice Statements. We will continue assess how else we can support the establishment of the principles contained within these Statements.

4.10. One area which pension funds could perhaps better utilise to reinforce a more long-termist perspective is via their assessments of the sponsor covenant. Within these private exercises trustees could be encouraged to more often consider factors beyond the financials, such as the sponsor company’s strategy and governance

⁵² *Pension Charges Made Clear: A Joint Industry Code of Conduct*

⁵³ NAPF Engagement Survey: pension funds’ engagement with investee companies, 2012

⁵⁴ NAPF Stewardship Policy, 2012

structures. While funds are encouraged to require their investment managers to take these factors into consideration when assessing investee companies, it is the investment from their sponsor which is perhaps most critical and with whom they have the most intimate relationship.

5. COLLABORATION AMONGST INSTITUTIONAL INVESTORS

5.1. While pension funds have reduced materially their exposure to UK equities in recent years, they remain significant investors in UK the market. However, it is clear that with this trend it is increasingly difficult for companies to easily “speak” to their shareholders and for shareholders to exert influence over their investee companies.

5.2. On this issue, it is worth reiterating the NAPF’s belief in the value of building scale and having fewer, larger schemes. In addition to helping savers secure better retirement outcomes because of the scale and efficiency they would bring, an increase in scale would leverage the voice and thus influence of pension funds in relation to their stewardship of investee companies.

5.3. The NAPF believes that engagement with investee companies is a vital part of the investment management process, however, as we know, pension funds are increasingly delegating their engagement activity to their investment manager. Our Engagement Survey therefore has for the past few years tracked the (perceived) level of collaboration amongst pension funds’ fund managers. For each of the past two surveys the response has been the same with 60% of respondents indicating that they are not aware of their fund managers collaborating with other investors on their behalf.

5.4. The recently published NAPF Stewardship Policy also picks up on this theme and states that funds should encourage collaboration between investment managers as a means of more effective engagement and voice. In addition, they should be clear about their managers’ approach and should expect a report on such collaboration.

5.5. We are however, very aware that a huge amount of collaboration amongst UK investors does take place, often on an informal basis. Indeed, we ourselves regularly host collaborative engagement meetings for our members with companies. This coordination role is one that is also performed by the ABI and other more informal groups such as the Corporate Governance Forum.

5.6. In the UK there are few obstacles to effective engagement between companies and their shareholders. However, the European Transparency Directive has been cited by some funds as a potential barrier to collaboration, given that an intention to vote at a company meeting in collaboration with other shareholders could require disclosure ahead of the meeting date. This presents potentially severe practical problems to investors and could inhibit effective collaboration. The recent announcement from the European Commission that as part of their company law and corporate governance action plan they will seek to increase legal certainty on whether collective engagement on governance matters falls foul of the rules on acting in concert is therefore a very positive one.

5.7. Professor Kay in his report recommends the creation of an Investors Forum to facilitate collective engagement by investors in UK companies. This proposal is one that has prompted a large amount of discussion by those in the industry and more widely.

5.8. As indicated above, we are conscious that a significant amount of collaboration already takes place amongst UK investors, however, as our Engagement Survey indicates, this is not always visible to the end clients, the press or the public. It is vital to keep in mind the necessity for most company engagement to take place in private, if these meetings were to become more public then the quantity and quality of the engagements would suffer.

5.9. That said, we do see merit in considering how investor collaboration can be further supportive and encouraged, especially in light of the broadening spread of a company’s investor base to include many more overseas and smaller investors. The NAPF therefore supports the creation of an investors’ forum that brings investors together to discuss, in a collaborative way, issues affecting them. It is important however, that any such forum is led by investors for investors.

6. ALIGN DIRECTORS’ PAY WITH LONG-TERM PERFORMANCE

6.1. The Kay review called for a revision of executive pay as part of the solution to short-termism in the markets. The Government in its response indicated that it too believes that Professor Kay’s prescription for long-term incentives—that these should be in the form of shares to be held beyond the individuals’ departure from the company—is an idea which companies should actively consider.

6.2. In recent years the NAPF has emphasised the need for pay restraint, coupled to improved transparency and greater simplicity. We welcome the recent attention on the issue which has helped focus minds on the need for a more fundamental rethink of executive pay structures to ensure much better alignment between rewards to management and the interests of long-term investors such as pension funds.

6.3. In February 2012 the NAPF and Hermes Equity Ownership Services (which undertakes voting and engagement for BTPS and other pension schemes) held an event on executive remuneration which was attended

by 44 FTSE 100 companies together with large pension funds both from the UK and overseas including RPMI Railpen and USS Investment Management.

6.4. Our sense from this, and other private and group meetings, is of a growing desire among many companies to re-evaluate current remuneration arrangements and embrace a new approach. We believe there is now an opportunity, which should be seized by companies and investors, to better align pay with the long-term owners of companies.

6.5. We firmly believe that the best form of alignment between executives and shareholders is the ownership of shares over the long-term, with ownership obligations increasing with seniority. The bulk of executives' variable rewards should flow over time from the benefits of being an equity owner. This approach we believe will help position companies for future success—an objective shared by all.

7. CONCLUSION

7.1. In conclusion, the NAPF is very supportive of attempts to consider the vital issue of how to structure the market such that it incentivises and rewards long-termism.

7.2. Pension funds by their very nature are long-term investors. However, in recent years, as a result of the move by investors around the world to diversify outside their domestic market, the growing maturity of many DB schemes and the effects of pension regulation introduced in recent years, there has been a trend away from UK equities. On the whole though pension funds still remain significant investors in UK the market and their interest in a successful UK corporate sector extends beyond that of an equity investor to that of an unsecured creditor, by virtue of the sponsor backing of private sector schemes.

7.3. We believe that what is needed is a regulatory environment which is more supportive of longer term risk-taking by pension fund investors—specific obstacles include accounting standards; inflexibility around recovery plans; and Solvency II (via the IORP Directive). In addition the positive trend towards greater transparency around investment fees and charges needs to be maintained.

7.4. Our research indicates that pension funds are embracing their stewardship responsibilities and our recently published NAPF Stewardship Policy explains further how funds should fulfil these responsibilities. However, our Engagement Survey also indicates that others in the investment chain have yet to embrace their responsibilities in this area.

7.5. This point highlights one of the more underwhelming aspects of the Kay report, that being the lack of any firm recommendations to address the issues raised with regards to the length (and cost) of the investment chain. Whilst the positive effort to improve transparency over charges and fees is important more is perhaps needed here.

7.6. Given the growing geographical diversity of the shareholder base for most companies it is unlikely that many will in future be able to rely on the support of a few stable, long-term shareholders. As such this places a greater onus on boards to develop a strategy, assess its execution and communicate this ever more effectively to their investors. In hand with this, institutional investors need to continue to develop effective mechanisms through which to collaborate. As such the NAPF will be working with others to assess how Professor Kay's recommendation for an Investors Forum can be practically and effectively progressed.

7.7. Finally, we agree with the logic of the government publishing a progress report, in Summer 2014, to highlight progress across this agenda. This a broad and vital agenda and it is important that momentum is maintained in order that change is achieved.

David Paterson
Head of Corporate Governance
 NAPF
 18 January 2013

Written evidence submitted by the Quoted Companies Alliance

The Quoted Companies Alliance is an independent membership organisation that champions the interests of small to mid-size quoted companies. Their individual market capitalisations tend to be below £500 million.

The Quoted Companies Alliance is a founder member of EuropeanIssuers, which represents over 9,000 quoted companies in fourteen European countries.

Our Corporate Governance Expert Group has examined your proposals and advised on this response. A list of members of the Expert Group is at Appendix A.

RESPONSE

We are grateful for the opportunity to submit our views to you on the recommendations emanating from the Kay Review.

Whilst we are generally supportive of the recommendations made by Professor Kay, we continue to have major concerns that the Kay Review has been developed on an assumption that the equity markets no longer have a primary, finance raising function. The report says:

2.6 Equity markets have not been an important source of capital for new investment in British business for many years. Large UK companies are self-financing—the cash flow they obtain from operations through profits and depreciation is more than sufficient for their investment needs. This is true of the quoted company sector as a whole and of a large majority of companies within it.

2.7 Finance raised through placings and rights issues by established companies, and initial public offerings (IPOs) by new companies, have generally been more than offset by the acquisition of shares for cash in takeovers and through share buyback (see Figure 4). New equity issuance has therefore been negative over the last decade.

Equity markets remain an essential source of capital for new investment in British business. Small and mid-size quoted companies are not self-financing and are undertaking activity which is rarely supported by senior finance, whatever the investment environment. Essential finance for the development of new economic growth is raised through share placings and rights issues by established companies and through IPOs by new companies.

Since the launch of AIM in 1995, over £80 billion of capital has been raised through new and further issues. This may have been offset by the acquisition of shares for cash in takeovers and through share buybacks. However, the larger companies, which conduct major programmes for the acquisitions of shares, are mature, ex-growth companies. Such companies are stable cash-generative machines which, understandably, return cash to shareholders. Large multinational companies listed in the UK do not typically create new employment in the UK and the rest of Europe.

Inevitably, the amount of cash returned to shareholders by larger companies is a greater amount than that raised by small and mid-size quoted companies—or “growth companies”. Each growth company needs essential capital to develop; often this is not a great amount. The cash volumes raised by growth companies are necessary to deliver new employment, economic activity, government revenues and economic returns to investors. Even if this is, in total, a smaller amount than that paid back to shareholders by large companies, each pound invested to deliver new growth is worth a multiple in the wider economy, as has recently been highlighted in Lord Heseltine’s report *No Stone Unturned in Pursuit of Growth*.

We urge the Select Committee to focus on the role of equity markets as a key source of capital for growth companies. Private equity and corporate debt have a role to play but companies need a range of options and equity markets need to be one of these, not least as an exit route for early investors. The most recent QCA/BDO Small and Mid-Cap Sentiment Index,⁵⁵ published in November 2012, reported that in terms of funding sources public equity and listed debt issuance were both growing in attractiveness at the expense of bank finance and private equity. 50% of respondents chose public equity as their preferred source of finance if the need arose in the next 12 months.⁵⁶

We agree with Professor Kay’s analysis that at the present time the primary equity markets are not functioning effectively. We believe that it is time for a fundamental review of the primary equity markets to ensure they are fit for purpose to support the raising of capital and the liquidity that goes hand in hand with investment both in 2013 and for the years to come. The continued concentration of mind by regulators, policymakers and lawmakers, at both UK and European levels, on share trading in the largest companies in the secondary market means that the primary equity markets are being starved of essential support in the delivery of investment and capital.

QUOTED COMPANIES ALLIANCE CORPORATE GOVERNANCE GUIDELINES FOR SMALLER QUOTED COMPANIES

The Select Committee will be interested to be aware that we are currently reviewing our *Corporate Governance Guidelines for Smaller Quoted Companies* (last published in September 2010), which is the industry benchmark for AIM companies, to take account of evolving best practice and, amongst other things, new legislative initiatives at UK and European level, evolution in the UK Corporate Governance Code and the Stewardship Code and the work of Professor Kay. In our update we will be incorporating the key features of the Good Practice Statement for Company Directors into the text and, more generally, promoting this part of Professor Kay’s work as a helpful guide to directors and companies, along with an increased focus on the need for effective Stewardship and the benefits of all types of Diversity.

If you would like to discuss any part of our evidence in more detail, we would be happy to attend a meeting.

Tim Ward

⁵⁵ <http://bdoqcasentimentindex.co.uk/>

⁵⁶ The survey figures are based on a quarterly online survey across the small and mid-cap quoted sector, with members and associates of the Quoted Companies Alliance (QCA) and contacts of BDO. The responding sample is weighted by industry to be representative of small and mid-cap UK quoted companies, as derived by the London Stock Exchange. Fieldwork was undertaken by research company YouGov. Fieldwork for the November Index was undertaken between 12/09/12 and 03/10/12, and the sample size was 200 adults. The survey respondents included 74% of small and mid-cap company employees in a board level position and 45% of advisors in a senior management position.

Chief Executive
18 January 2013

APPENDIX A

QUOTED COMPANIES ALLIANCE CORPORATE GOVERNANCE EXPERT GROUP

Edward Craft (Chairman) Wedlake Bell LLP
Victoria Barron Hermes Equity Ownership Services
Edward Beale Western Selection Plc
Tim Bird Field Fisher Waterhouse
Dan Burns McguireWoods
Anthony Carey Mazars LLP
Louis Cooper Crowe Clark Whitehill LLP
Victoria Dalby Capita Registrars Ltd
Kate Elsdon PricewaterhouseCoopers LLP
David Firth Penna Consulting PLC
David Fuller CLS Holdings PLC
Clive Garston DAC Beachcroft LLP
Nick Graves Burges Salmon
Alexandra Hockenhull Xchanging plc
David Isherwood BDO LLP
Nick Janmohamed Speechly Bircham LLP
Colin Jones UHY Hacker Young
Dalia Joseph Oriel Securities Limited
Doris Ko Aviva Investors
Claire Noyce/Deepak Reddy Hybridan LLP
James Parkes CMS Cameron McKenna LLP
Julie Stanbrook Hogan Lovells International LLP
Peter Swabey Equiniti
Eugenia Unanyants-Jackson F&C Investments
Melanie Wadsworth Faegre Baker Daniels LLP
Cliff Weight MM & K Limited

Written evidence submitted by BlackRock

BlackRock welcomes the opportunity to respond to the request for evidence made by the House of Commons and the Department for Business, Innovation & Skills on the Kay review. We set out in the attached response our view on 16 of the 17 principles recommended by Professor John Kay in his final report published in July 2012.

BlackRock is a leader in investment management, risk management and advisory services for institutional and retail clients worldwide. As at 31 December, 2012, BlackRock's AUM was \$3.792 trillion (£2.332 trillion). BlackRock offers products that span the risk spectrum to meet clients' needs, including active, enhanced and index strategies across markets and asset classes. Products are offered in a variety of structures including separate accounts, mutual funds, iShares® (exchange-traded funds), and other pooled investment vehicles. BlackRock also offers risk management, advisory and enterprise investment system services to a broad base of institutional investors through BlackRock Solutions®.

In Europe specifically, BlackRock has a pan-European client base serviced from close to 20 offices across the continent. Public sector and multi-employer pension plans, insurance companies, third-party distributors and mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals invest with BlackRock. BlackRock pays due regards of its clients' interests and it is from this perspective that we engage on all matters of public policy. BlackRock supports regulatory reform globally where it increases transparency, protects investors, facilitates responsible growth of capital markets and, based on thorough cost-benefit analyses, preserves consumer choice.

BlackRock is a member of European Fund and Asset Management Association ("EFAMA") and a number of national industry associations⁵⁷ reflecting our pan-European activities and reach.

We thank you for the opportunity to address and comment on the issues raised by the Kay review. We are prepared to assist the House of Commons and the Department for Business, Innovation and Skills in any way we can, and look forward to continued dialogue on these important issues.

Joanna Cound

⁵⁷ Association of British Insurers (ABI), Association Française de Gestion (AFG), Assogestioni, Association française des Sociétés financières (ASF), Association suisse des institutions de prévoyance (ASIP), Bundesverband Investment and Asset Management (BVI), Dutch Fund and Asset Management Association (DUFAS), Eumedion, Financial Reporting Council (FRC), Irish Association of Pension Funds (IAPF), Irish Funds Industry Association (IFIA), Investment Management Association (IMA), Inverco, Alternative Investment Management Association (AIMA) and National Association of Pension Funds (NAPF).

*Managing Director
Head of EMEA Government Affairs & Public Policy*

*Amra Balic
Director
Head of Corporate Governance and Responsible Investment EMEA*

18 January 2013

EXECUTIVE SUMMARY

1. BlackRock is supportive of most of Professor John Kay's 17 Recommendations developed in his final report on his review of the UK equity market.

2. BlackRock strongly supports the continuing development of a robust corporate governance regime. This, in our opinion, promotes strong leadership by boards and good management practices both of which contribute to the long-term success of companies and protects and enhances long-term shareholder value. As such, we engage with companies in which we invest on behalf of our clients dedicating our time generally to one-to-one meetings where we discuss, amongst other issues, the companies' strategic direction and the performance of management in delivering strategy.

3. BlackRock believes that there are merits in the development of the formation of an investor forum to strengthen corporate governance in companies in which we invest but has a number of reservations as to its scope of engagement and relationship with existing forums led by trade associations. In addition, while we discuss collectively with other investors when we believe this is likely to enhance our ability to engage with a company, the establishment of an investor forum poses a number of challenges which we develop in our attached response. Also, BlackRock does not think mandatory consultation by companies of their major shareholders over board appointments is appropriate for companies and/or investors. This would raise several practical questions such as inside information issues.

4. BlackRock does not consider that further changes to the application of fiduciary standards by asset managers at an EU level are required. BlackRock fully understands and endorses its duty to act at all times in the best interests of clients to protect and enhance the economic value of the companies in which we invest on their behalf.

5. With regards to transparency *vis-à-vis* asset managers' clients, BlackRock is supportive of initiatives aiming at improving transparency of costs and fees. However, disclosing the full costs of certain transactions might not be technically feasible for asset managers. In addition, we support and already provide a high degree of transparency to end-investors in respect of stock lending activity. A portion of the additional income that this activity generates for end-investors is allocated to compensating the lending agent for the provision of this service. After the payment to the lending agent has been deducted, we agree that the remaining net revenue should be passed to the end-investors as incremental income.

6. With regards to transparency *vis-à-vis* companies' investors, BlackRock believes that the informative quality of the narrative reports should be improved and be presented in a concise and clear way. We support guidance rather than regulation to achieve this objective. However, we believe that quarterly reports potentially create an undue focus on short-term developments that may have little material impact over the longer term. We therefore agree that quarterly reporting should no longer be mandatory.

7. BlackRock welcomes the Government initiatives to explore with market participants, the regulators, academics and relevant representative and professional bodies the metrics and models used in the investment chain.

8. BlackRock agrees that "companies should structure directors' remuneration to link incentives to sustainable long-term business performance". However, we are not supportive of directors having to hold the shares of the company in which they work until after they have retired from the business as this could incentivise a higher turnover of directors in the company who leave simply in order to cash in their shares contrary to the long term interest of the company. BlackRock is also of the view that asset management firms should structure remuneration to align their interests with those of their clients. We show evidence in our detailed response that BlackRock's compensation structure encourages a focus on the medium to long-term.

9. Finally, BlackRock fully agrees with Professor John Kay that it is key for individual investors to have all their rights preserved when holding shares through electronic means at a cost-efficient basis. We would welcome any initiatives which may reduce the cost of electronic trading intermediation for individual investors and encourage their ability to vote.

INTRODUCTION

In this response, BlackRock expresses its views on 16 of the 17 Recommendations given by Professor John Kay in his final report published in July 2012. We provide as much as possible factual information and recommendations for actions that we hope will be insightful for the House of Commons and the BIS.

BLACKROCK'S RESPONSE TO THE HOUSE OF COMMONS AND BIS REQUEST FOR EVIDENCE ON THE KAY REVIEW

(1.) The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.

10. BlackRock agrees with Professor John Kay's first recommendation. In our experience, the most important factors in determining success of a company are the strong leadership and execution of a company's strategy. As part of our engagement with companies, the BlackRock Corporate Governance team discusses with companies in which we invest strategy and execution issues and also aims to reach a better understanding on broader corporate governance policies and procedures and how executive pay is linked to achievement of the strategic goals.

11. It is worth noting that BlackRock approaches each engagement individually and does not have a prescribed escalation strategy, as suggested by the UK Stewardship Code, as we do not see engagement as mechanistic. Triggers for engagement can include our assessment that there is potential for material economic ramifications for shareholders resulting from a governance concern. Indeed, where we are concerned about the strategic direction the company is taking or the performance of management in delivering strategy, we will engage more heavily and through regular and frank meetings with management, we try as much as possible to raise queries before they become significant concerns that require greater attention.

12. BlackRock is very unlikely to make public statements about our engagements or to call an extraordinary general meeting or propose shareholder resolutions. Our preference is to engage privately as we believe it better serves the long-term interests of our clients to establish relationships, and a reputation, with companies that enhances rather than hinders dialogue.

13. Last, it is important to clarify that BlackRock defines stewardship as protecting and enhancing the value of the assets entrusted to us by our clients. As shareholders, our stewardship responsibility is to our clients. Yet we perceive a widespread belief that stewardship implies that shareholders have a responsibility to engage with companies and "make them better". This confuses the two responsibilities. Sometimes fulfilling our stewardship responsibilities to clients will involve engagement with companies; other times it will necessitate selling or reducing a shareholding if we cannot protect our clients' interests through engagement, which should not be seen as a derogation of our duty, but a fulfilment of it.

(2.) Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Kay review's Good Practice Statements.

14. BlackRock supports this second recommendation made in the final Kay report. We are a member of the Institute of Chartered Secretaries and Administrators (ICSA) steering group created in the summer of 2012 to improve the Quality of Investor Stewardship. This was at the request of the 2020 Investor Stewardship Working Group, of which BlackRock is a founding member. The steering group is developing a good practice guide to improve the quality of engagement activity and aims to identify more effective means for companies and institutional investors to provide feedback on the quality of meetings.

15. BlackRock believes that corporate governance and engagement are an integral part of an asset manager's fiduciary duty to enhance the value of its clients' assets and to ensure management are running the company in the best long-term interest of shareholders. In observance of our fiduciary duties to our clients, we: (i) as already mentioned above, engage with companies we invest in on a number of corporate governance and performance related issues; (ii) vote at shareholder meetings (for those clients who have given us a legal right through the Investment Management Agreement to vote on their behalf) and (iii) engage on wider policy issues that are in our view fundamental to protection of investors and their rights as shareholders.

(3.) An investors' forum should be established to facilitate collective engagement by investors in UK companies.

16. In principle, we are in favour of creating an investor forum that would (further) facilitate collective engagement. However, we also acknowledge that there are some challenges, such as:

- Minimise/limit overlaps and duplication of efforts: the new forum needs to cover topics/issues that go beyond the typical discussions currently conducted through the existing industry bodies (ie Association of British Insurers (ABI), National Association of Pension Funds (NAPF) and Investment Management Association (IMA)).
- The forum's governance policies need to ensure confidentiality of the meetings and views expressed as this aspect will be the key determining factor of the forum's effectiveness and ultimate success.
- The governance policies and terms of reference also need to be designed to allow effective actions in a way which does not conflict with rules on market abuse and acting as concert party in view of a takeover bid.

17. As UK Plc. (companies registered in the UK) is decreasingly owned by UK savers, bringing some large foreign investors (such as sovereign wealth funds) to the table would broaden the discussion and enable exchange of views.

18. In general terms, as a large investor in UK companies, BlackRock will work with other investors, often on an ad hoc basis, when we believe it is likely to enhance our ability to engage with a company or to achieve the desired outcome. This facilitates communication between shareholders and companies on corporate governance and social, ethical and environmental matters. We will also engage collectively on matters of public policy, when appropriate.

(4.) The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves.

19. We do not have comments on this principle.

(5.) Companies should consult their major long-term investors over major board appointments.

20. BlackRock agrees in principle that companies should consult their major investors over the key board appointments. However, we do not see the need to make this consultation mandatory for companies and/or investors. Both parties should be allowed to determine if or when the consultation is necessary. We also acknowledge that there are some practical issues surrounding this type of engagement and consultation that need to be discussed further. Specifically, there are issues in relation to inside information and wall crossing, timing of consultation and subsequent communication with investors.

21. It is also worth pointing out that today companies and investors are already engaging over the major appointments but those conversations vary for the reasons cited above. At a minimum, investors will have a view on the background and skill set required. At the same time, investors will unlikely want to be made insiders for an extended period of time depending on a number of factors such as investment strategy, size of holding, company performance etc. In this case, we would urge the House of Common and BIS to take into account current developments in the market abuse regime such as the European Union Market Abuse Regulation and to ensure that appropriate balance is reached between investors' engagements and preventing market abuse.

(6.) Companies should seek to disengage from the process of managing short term earnings expectations and announcements.

22. Based on our experience in recent years, the demand for greater disclosure on short term earnings, such as quarterly reporting and the operating review, has helped boards to communicate better their long-term strategic objectives. However, quarterly reporting does potentially places undue focus on short-term developments that may have little material impact over the longer term. Too frequent disclosure can make the market lose sight of the longer term objectives and judge the company on its short-term achievements. This, in turn, might make it more difficult for boards to focus on the long-term development of their business. Therefore, BlackRock supports moves to drop the requirement for mandatory quarterly reporting. This will allow companies to be freer to disengage from the process of managing short term earnings expectations and announcements and focus more on their long-term objectives. We develop this point further in our comments to Recommendation 11.

(7.) Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.

23. BlackRock does not consider that implementing a new fiduciary standard at an EU level is required for asset managers. We believe that UK asset managers understand their obligations, which include contractual (setting the scope of who a manager's customer is, the guidelines to be applied, etc.) and regulatory (both at an EU or UK level) duties. These are high standards already.

24. In the UK we understand that fiduciary responsibility has been developed (and continues to develop) by case law and introducing an EU wide standard which cannot be contractually overridden may cause confusion and perhaps affect the competitiveness of the UK asset management industry.

(8.) Asset managers should make full disclosure of all costs, including actual or estimated transaction costs and performance fees charged to the fund.

25. BlackRock fully supports initiatives aiming at improving transparency of costs and fees. We do note that there are a number of ways of addressing this issue and in particular, for retail investors, this needs to be coordinated at a European Union level as part of the packaged retail investment products (PRIIPS) initiative.

26. However, providing full transparency of costs for non-equity product presents a number of challenges such as the effects of spreads on fixed income instruments. It is important that a common methodology is agreed which can apply across all product ranges.

27. Also, given unbundling of advisory fees from product specific fees in the UK retail distribution review (RDR), it is important that investors have a clear way of assessing total product cost and total investment cost (ie product and advice costs together). Asset managers will only be able to disclose the product cost to the end-investors but not the full cost of investing given they will not have information post-RDR on the fees end-investors will have to pay to the advisers. BlackRock is supportive of clear disclosure delivered by advisers to clients regarding the new fee arrangements.

28. As a member of the IMA and the NAPF, BlackRock endorses the efforts of both organisations to establish industry wide best practice on fee transparency and is currently working towards compliance across all client communication channels.

(9.) *The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers.*

29. BlackRock cannot comment on uncertainties and misunderstandings on the part of trustees. As referred to in Recommendation 7 above, we do not believe that additional clarity is needed for UK asset managers regarding the rules around being a fiduciary as these rules are sufficiently well understood under English law.

(10.) *All income from stock lending should be disclosed and rebated to investors.*

30. Stock lending is a well-established and low risk activity that is comprehensively regulated in Europe. Investment vehicles such as UCITS funds, ETFs, pension funds and insurance companies make short-term loans of their securities to banks and broker dealers, who, in return, provide collateral that is in excess of the value of the underlying loans. The funds receive the full economic value of the security lent including any dividends paid, and further receive a fee for lending their securities, which generates incremental returns for their portfolios contributing to the overall investment performance.

31. In addition, stock lending has wider benefits for financial markets as it provides liquidity that helps to improve settlement efficiency and contributes to tighter trading spreads for investors.

32. Stock lending is considered to be a low risk activity. The risk mitigation tools utilised include using high quality counterparties, over-collateralisation, and in some cases contractual indemnifications against losses as a result of borrower default.

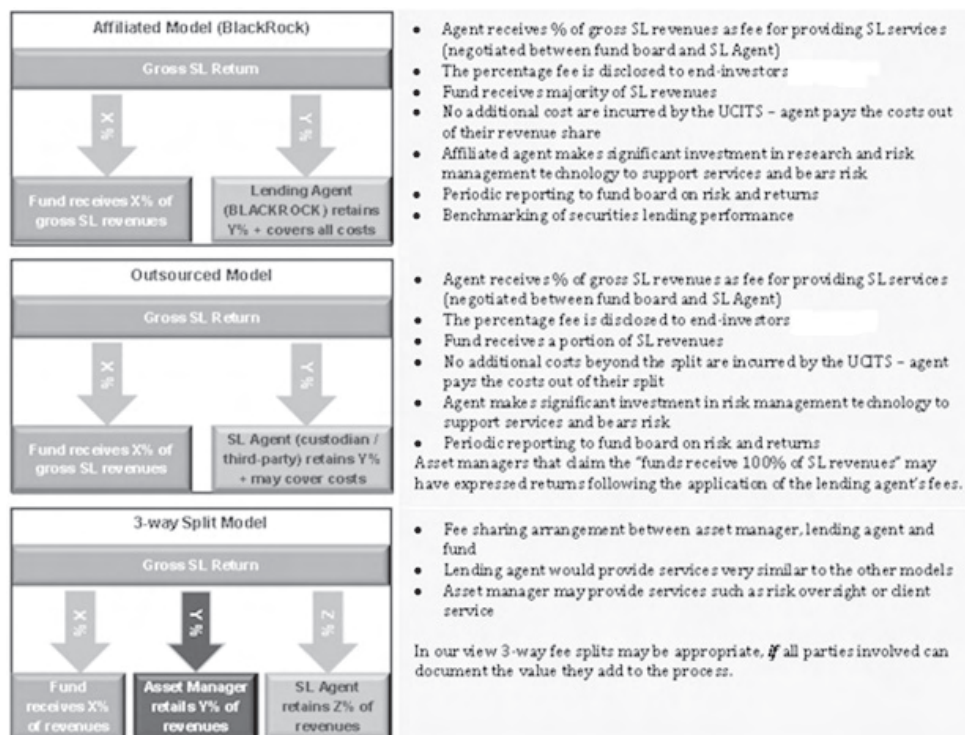
33. We support efforts to increase transparency on stock lending activities for end investors to ensure that are fully informed of the nature of risks and returns involved from this activity. We further support disclosure of the fees paid in connection with securities lending, in the same manner as other fees paid to fund service providers are disclosed. However, we do not agree that all income should be passed to investors given that running these activities represents a cost for the lending agents appointed by the funds.

- Stock lending is a resource-intensive activity. A high proportion of stock lending trades are executed automatically, which requires significant investment in systems and technology. A smaller number of trades are negotiated manually, where pricing can be influenced by many variables, and the outcome for end investors can be significantly improved through the application of quantitative and fundamental research and analytics. In addition, investment in risk management capabilities is required to continuously review counterparties and collateral parameters. Significant resources are also required to monitor settlement, collateralisation and corporate actions activity. These investments permit the lending agent to provide their trading expertise, scalability and risk controls across all lending clients. It is difficult to assign these costs to specific lending clients.

34. As a result, beneficial owners and the stock lending industry have established a model whereby the lending agent receives a percentage of gross revenues for their service of providing stock lending services. This model ensures that the lending agent is compensated only if the lending client generates revenue for the fund. In our view, paying the lending agent a percentage of the gross revenue generated is the most appropriate way of ensuring alignment between the interests of the investors and the lending agent.

35. There are at least three active compensation models being used for stock lending in the European markets today:

- (1.) *Affiliated Model:* In-house lending programmes, where the asset manager or an affiliate performs stock lending services as the lending agent. The agent receives a portion of the gross stock lending revenue generated.
- (2.) *Outsourced Model:* All stock lending services are outsourced to a lending agent, which could be a custodian, another asset manager or a specialised third-party lending provider. As before, the agent receives a proportion of the gross stock lending revenue generated.
- (3.) *Three-Way Split Model:* Stock lending is outsourced as in the second model, but the investment manager also receives part of the stock lending revenues. Fees are split between lending agent, fund and asset manager.



36. As explained above, we are not supportive of having all of the gross income generated from stock lending passed to end-investors. However, we do agree that transparency should be provided to clients so that they fully understand revenue sharing arrangements. We also believe that the cost of operating a lending programme should be paid by lending agent from their portion of the income. After the payment to the lending agent has been deducted, we agree that the remaining net revenue should be passed to the end-investors as incremental income.

(11.) *Mandatory IMS (quarterly reporting) obligations should be removed.*

37. As already mentioned on our comments to Recommendation 6, BlackRock supports moves to drop the requirement for mandatory quarterly reporting. While further investigation into the impact of quarterly reporting might be worthwhile, we believe that quarterly reporting potentially places undue focus on short-term developments that may not have a significant impact over the longer term.

38. Also, we think that consideration might be given to whether there should be more flexibility in reporting requirements, which can be disproportionately costly for smaller companies. Investor pragmatism and engagement would ensure that the right balance is achieved between meeting shareholder expectations and not unduly burdening smaller companies.

12) *High quality, succinct narrative reporting should be strongly encouraged.*

39. BlackRock agrees with this principle. We believe that the informative quality of the narrative reports should be improved whilst giving companies an appropriate level of flexibility in respect of the nature and scope of disclosure. We support guidance rather than regulation that would focus on balancing the need for reports to be complete and comparable with the need to be concise and accessible to all users.

40. Also, when preparing the annual report companies should focus on the matters material to the long-term success of the company and those that explain performance during the period under review. All focus should be on providing information to investors that is useful for making their investment decisions. We think that narrative highlights should give both what is most material in the long/medium term outlook and what the companies believe are material changes to previous narratives about that outlook. The areas that a business decides are most applicable can itself contain useful information. However, while we see value in providing additional information (as mentioned above), we also urge companies to present them in a concise and clear way.

(13.) *The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations.*

41. BlackRock welcomes the Government initiatives to explore with market participants, the regulators, academics and relevant representative and professional bodies the metrics and models used in the investment chain.

(14.) *Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment.*

42. BlackRock fully agrees with this principle.

(15.) *Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business.*

43. BlackRock agrees that "companies should structure directors' remuneration to relate incentives to sustainable long-term business performance". However, we do not believe that company shares are the only asset that can incentivise directors' long term performance. In some cases and in certain industries, shares coupled with subordinated debt/bonds can also be efficient. We do not agree either that the directors should hold the shares until after they have retired from the business as this may lead executives to leave the company when they think it is the best timing to cash in with adverse effects on the long term interest of the company.

(16.) *Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund.*

44. BlackRock agrees that asset management firms should structure remuneration to align the interests of asset managers with the expectations of their clients.

45. BlackRock's approach to compensation reflects the value senior management places on its clients, employees and shareholders. Consequently, the compensation structure is designed to align with client and shareholder interests, to reflect performance and to attract and retain the best talent and to reinforce stability through the organisation.

46. The predominant compensation model includes a salary and a discretionary bonus reflecting firm, business area, and individual performance. For most investment professionals, compensation reflects investment performance over the short, medium and long term and the success of the business or product area and the firm Variable compensation deferred from annual bonus awards is paid out in BlackRock's stock which vests over a number of years. In addition, a limited number of investment professionals have a portion of their annual discretionary awarded as deferred cash that notionally tracks investment in selected products managed by the employee. The intention of these awards is to align further investment professionals with the investment returns of the products they manage through the deferral of compensation into those products. Clients and external evaluators have increasingly viewed more favourably those products where key investors have "skin in the game" through significant personal investments. However, such co-investment is not always possible. For example, as a result of the significant compliance burden with respect to the US Foreign Account Tax Compliance Act (FATCA), a US national is generally precluded from investing in a UK fund. The combined effect of this approach means that the variable compensation an investment manager receives in any one year reflects the investment performance achieved over a considerable time period. BlackRock believes that this correctly aligns compensation with the client experience and that it is not appropriate for the incentive to be held until the investment manager is no longer responsible for a particular fund. The compensation structure outlined above is designed to retain best talent and reinforce stability of personnel (because clients select managers on long term performance and stability of investment processes and personnel). Withholding the deferred compensation until the investment manager no longer is responsible for the fund could instead encourage greater personnel turnover.

(17.) *The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.*

47. BlackRock would welcome initiatives which may reduce the cost of electronic trading intermediation for individual investors and safeguard and encourage their ability to vote. As such, we are of the view that it is important to find the most cost effective means for individual investors to hold shares electronically in their own name. We note that investors already have the ability to hold their shares electronically through nominees which represents a less significant cost for them than holding the shares in their own name. However, we are of the view that individual investors should have all their rights preserved when holding shares through electronic means.

48. BlackRock also believes that any such initiative needs to be viewed in the context of central securities depositaries and the proposed securities law directives.

Written evidence submitted by UK Shareholders Association

EVIDENCE TO THE BUSINESS, INNOVATION AND SKILLS COMMITTEE ON THE GOVERNMENT RESPONSE TO THE KAY REVIEW

UK Shareholders' Association is a long established non-profit body representing the interests of individual shareholders. In addition to the services we provide to our own members, we have a 20 year record of making representations to various public authorities on behalf of private investors in general, including three submissions to the Kay Review. We have a collective experience derived over many years from numerous, mainly long-term, investors. We also strive to play a role in the education of our members and investors generally. We are entirely funded by subscriptions from our members.

EXECUTIVE SUMMARY

In this paper we express our disappointment with the Government Response, which lacks any sense of urgency and drive despite the Review being relevant to the overall economic performance of this country, as well as to relationships between companies and their shareholders. We give just a few examples from the Response to illustrate our concerns. One is the reliance on a broad group of departments and regulators to achieve progress on examination of law and regulation with a leisurely timetable but no one person or body indicated as driving it forward. Another is the reliance on the Stewardship Code despite evidence that it is not effective. A third is the excuse of waiting for European directives before taking action on rights for private shareholders.

OUR EVIDENCE:

1. We are extremely disappointed with the whole tone and attitude of the Government response, which has lost all the sense of urgency and initiative that accompanied the setting up of the Review when it was announced in June 2011. The Review does not merely deal with relationships between companies and shareholders but it leads into wider issues which have contributed to the economic decline of this country. For example, Professor Kay highlighted early in the Review the fact that both Business Investment and R&D investment in the UK have fallen in recent years and both are now significantly below those of our principal trading competitors. This aspect of the Review is passed over in the Government response and yet we would have thought this would be a key feature especially in the light of the difficulties there have been in engendering economic growth.

2. We are well aware that, while Kay gave an excellent analysis of what is wrong at present, and described the ideal situation he would like to reach, his route map for achieving the desirable result was lacking in detail. The Secretary of State seems to have accepted this as a reason for relying largely on market participants to achieve progress and, where Government is directly involved, not to propose any further progress report until summer 2014. We believe, on the contrary, that very little is likely to be achieved without a strong push from Government. Moreover any review dependent on "market participants" will surely be biased towards the interests of the financial services industry, which largely conducts its affairs with other people's money; those whose money it usually is, namely private investors and savers, are usually absent from such reviews and so need the Government to act on their behalf.

3. We continue by giving specific examples of some points in the Response where we can make positive suggestions.

4. CHAPTER 2

In paragraph 2.22 The Government "calls upon market practitioners to have regard to these principles". This in our view is completely inadequate to achieve any progress. A positive way forward would have been for the Secretary of State to call industry leaders together to bring their influence to bear in establishing these principles and threatening them with legislation if they failed to do so. In paragraph 2.29 the Response proposes to take forward the identification of changes in law and regulation by expecting three government departments plus the Cabinet Office to work jointly with five regulators. There is no indication in the Response of any one individual or Department having been given any power or responsibility to drive this forward. Moreover only in summer 2014 are we to hear how the Review is to be used to inform future policy development. That will be already two years from the publication of the Review, three from its commissioning and less than one year from a general election. This leisurely approach is totally inappropriate.

5. RECOMMENDATION I

The response here places great reliance on the development and application of the Stewardship Code. While we are supportive of the FRC's introduction of this Code and note the list of companies that have publicly signed up to it, which is no small achievement in itself, we have consistently pointed out the lack of incentive for major shareholders handling other people's money to allocate the necessary resources to make a good job of it; in fact, competitive factors provide a disincentive.

We are currently dealing with a case of an executive compensation scheme in a FTSE 250 company which appears to have been devised simply as a means of transferring wealth from the shareholders to the executives with very little in the way of performance requirement to achieve this. It is evident from the voting figures that

major institutions voted in favour of this package despite all its weaknesses and these appear to include some who have signed up to the Stewardship Code. This demonstrates that the Code is not working and that Government should be looking for alternatives such as shareholder committees involving shareholders with a real, long-term economic interest. We believe that this would provide a more fruitful opportunity for progress than the forum proposed in Recommendation 3.

6. RECOMMENDATION 10

At first sight the Government appears to have accepted this recommendation. However, closer reading indicates that they have skated over the possibility that stock-lending is carried out in whole or part for the benefit of the asset manager even though it is at the risk of, and possibly against the interest of, the ultimate investor. Here again there is a complete reliance on the investment industry to make progress coupled with a lack of urgency by deferring any further consideration to summer 2014.

7. RECOMMENDATION 17

7.1 The issues addressed by Professor Kay's final recommendation are long-standing and becoming more serious as time goes by. More and more shares have to be held through nominee accounts, either because the Government requires this for ISAs and SIPPs or under pressure from brokers because this gives them a degree of control from which they derive commercial benefit. This leads to the failure of shareholder democracy, loss of control over one's investments and the weakening of the pressure that private individuals are able to apply to boards of directors by challenging them at AGMs. Moreover, it appears to be a direct obstacle to the holding of shares by individuals, whereas we would have expected the Government to want to encourage this as a means of saving, with the additional benefit of wider understanding both of the way wealth is created and of the capitalist system in general.

7.2 As illustrated by Professor Kay, other countries have solved this dilemma although the countries he lists are not the only ones, and it seems to be unique to the UK. At the moment, the only way round the problem here is through holding a Personal Crest account. The idea of these becoming general is anathema to service providers for one reason and another and forbidden by HMRC for ISAs and SIPPs.

7.3 On page 31 of its response the Government gives potential EU legislation as a reason for holding back on further action. On the contrary, current EU proposals add considerable urgency to the need for progress since those concerning central securities depositories involve compulsory dematerialisation. If this were to occur without progress on Recommendation 17, the only private shareholders outside nominee accounts who retained their proper rights would be those who had adopted the Personal Crest system. Everyone else would be disenfranchised and AGMs would be non-functioning (a serious loss of director face-to-face accountability), since the vast majority of private shareholders would no longer have an automatic right to attend and vote.

7.4 Parliament should also be aware that, by means of Part 26 of the Companies Act 2006, it has allowed the acquisition of all of a company's equity without all its equity holders having a say in the matter. In corporate actions, of which this is the most dramatic, nominee account users, not being the legal owners of their shares, are usually excluded from the vote. Whether nominees vote the shares unbeknown to their clients is itself an unknown, but such acquisitions, now the majority, hand the acquirer 100% of the shares in what amounts to those disenfranchised as compulsory purchase, with no minimum voting participation (ie it can and has been less than 50%). The Government also loses revenue, because this method of acquisition avoids stamp duty.

7.5 Professor Kay expresses concern about the security of shares held in nominee accounts. The level of compensation available for loss of investments held in nominee accounts is just £50,000, whereas the equivalent figure in the USA is understood to be \$1m. Even if investors succeed in recovering all their investments when the nominee goes bust they will certainly have faced a lengthy period before any investment is returned or made available for sale. For ISAs and SIPPs, the Government denies savers the right to own their investments but has refused to recognise the extra financial risk this imposes.

7.6 It is essential that the Government legislates to remove the obstacles to what should be investors' right to be treated as full shareholders regardless of the means by which they hold their shares in individual companies. UKSA stands ready to contribute to the exploration of means that we acknowledge is first needed, but a clear lead from the Government on this crucial issue is needed now.

Roy Colbran, Head of Government Policy Group
John Hunter, Policy Team member
Eric Chalker, Policy Co-ordinator
20 January 2013

Supplementary written evidence submitted by UK Shareholders Association

THE KAY REVIEW

Having now read or heard the evidence of witnesses in the oral sessions before your Committee, we wish to submit some comments supplementary to our own written evidence.

SESSION WITH LORD MYNERS

In the light of our own evidence you will appreciate that we were delighted to see Lord Myners's criticisms of the government response which were expressed more clearly and succinctly than we could manage. A parallel organisation also representing individual shareholders has written direct to the Secretary of State expressing concern about the response.

Lord Myners said that he did not think you had a single true owner giving you evidence. In fact our organisation's evidence is supplied by and on behalf of individual true owners. Our members join our association, and pay their subscriptions, because they are direct personal holders of shares, seek the support which we provide and, in return endorse our efforts to improve the environment in which private investors operate.

That leads on to the question of the amount of shares in private ownership which was discussed in the session on 26 February. First, in case the Committee is not already aware of it, you should know that Richard Jenkinson, Managing Director of Junction RDS Ltd, disputes the official figures claiming that they understate the true position and that the current trend is upwards. He has compiled a massive database to demonstrate this. His work is being taken sufficiently seriously for the FRC to commission an investigation into his figures although that does not seem to have progressed. However, he has also had conversations with the Office for National Statistics and would tell you that they have admitted some changes in their methodology resulting from his comments.

A useful comparison is with Australia where the latest survey shows 39% of the adult population holding shares directly. In the UK the ONS figures measure by households rather than by individuals and have only 15.4% holding UK shares. Comparison of the help provided for private investors on the websites of the respective stock exchanges gives an indication of the differing official attitudes towards them.

We would certainly like to see the proportion of shares in private ownership in this country grow as we believe that a strong private shareholder base is healthy for the economy, it promotes understanding of the ways in which the wealth of the country is generated and provides opportunities for savers under their own control. Private shareholders take a direct interest in the companies in which they invest and ask penetrating questions at AGMs from which the institutions are generally absent. Unfortunately there are factors militating against growth in their numbers including the pressure from advisers to buy funds, the lack of rights through nominee shareholdings, the feeling that only institutions have all the advantages to cope with today's complexity and the complications of keeping records for capital gains tax.

THE INVESTORS' FORUM

We have read Professor Kay's proposals for an investors' forum several times and still do not fully understand how this is intended to operate. The intention appears to be to create one amorphous body covering the whole of the UK stock market and we do not believe this can be effective. Clearly the prime objective is to encourage the growth and development of UK plc with the secondary, but vital, objective of the benefits from this feeding down to investors and savers. We believe that specific bodies need to be set up for each company rather than having one forum covering the whole market. UKSA would like to see shareholder committees made up of private investors. An alternative suggestion is for shareholder committees largely made up of institutions but with a private investor element. In both cases these committees would be for consultation and communication. However, this raises the question of whether the point has been reached where the directors of a company are so much in control that a body with positive powers over them is necessary. In this connection it is worth pointing out that according to Ferdinand Mount⁵⁸, Sir Richard Greenbury (of the Greenbury Committee) now advocates two-tier boards on the Continental model despite having ruled them out in the past. Maybe the time has come to examine more closely how this system operates in continental Europe, bearing in mind that we see a stronger industrial base combined with greater investment and R&D in countries such as Germany which has the system.

KAY RECOMMENDATION 17—RIGHTS FOR HOLDERS IN NOMINEE ACCOUNTS

Our written submission to your Committee sets out our position in regard to the Government's response on this topic. Since we wrote, a Draft European Parliament Legislative Resolution (A7-0039/2013) has been issued incorporating a Draft Regulation which will give member states that have not fully dematerialised a deadline to do so. This, of course, includes the UK. The explanatory statement continues: "In order for shareholders to play a more active role exercising their rights over companies it is necessary that central registers be kept that will facilitate the use of these rights." It follows that there is now no excuse for the

⁵⁸ The New Few; Ferdinand Mount 2012, Simon and Schuster UK Ltd

Government to wait on Europe before working fully with the share registrars and representatives of private investors to achieve a satisfactory solution to this problem. Full enfranchisement of private shareholders is essential if they are to be encouraged and to play their full part in achieving Professor Kay's aspirations.

Roy Colbran
Head of UKSA Government Policy Group
11 March 2013

Written evidence submitted by the Chartered Institute of Personnel and Development (CIPD)

BACKGROUND

1. The CIPD is the leading independent voice on workplace performance and skills. Our primary purpose is to improve the standard of people management and development across the economy and help our individual members do a better job for themselves and their organisations. Our purpose is to champion better work and working lives, through improving people management and development practices to build greater value for organisations, benefiting economies and society.

2. Public policy at the CIPD exists to inform and shape debate, government policy and legislation in order to enable higher performance at work and better pathways into work, especially for young people. Our views are informed by evidence from 135,000 members responsible for the recruitment, management and development of a large proportion of the UK workforce.

3. Our membership base is wide, with 60% of our members working in private sector services and manufacturing, 33% working in the public sector and 7% in the not-for-profit sector. In addition, 76% of the FTSE 100 companies have CIPD members at director level. We draw on our extensive research and the expertise and experience of our members on the front-line to highlight and promote new and best practice and produce practical guidance for the benefit of employers, employees and policy makers.

GENERAL COMMENTS

4. Public opinion of big businesses, particularly in the financial sector, has nosedived following recent events that demonstrated a lack of fundamental ethical positions and responsibilities in certain organisations, as well as how widely the behaviour of others differed from their stated values and ethics. This is by no means confined to the banks—surveys of public opinion show a significant decline in trust in all types of businesses doing the right thing, as well as authoritative figures such as politicians.

5. Events ranging from the fixing of the LIBOR rate to the mis-selling of PPI insurance have pointed to a crisis of culture existing within these organisations (albeit also reaching beyond particular institutions and sectors). Over time, the understanding of an organisation's purpose has become unduly biased towards short-term performance measures, reinforced by misaligned remuneration incentives at different levels of the organisation, at the expense of a focus on longer-term performance and business sustainability.

6. We welcomed the insights, conclusions and recommendations made by John Kay in his review into UK Equity Markets. We believe that the state of affairs outlined above is linked to a decidedly short-termist outlook that certain organisations and sectors have embodied for some time, driven by a focus on short-term financial and share price performance reinforced by remuneration and reward practices. This has been accompanied by a real and apparently increasing lack of long-term-focused investment behaviour, which belies a lack of long-term thinking and a failure to properly account for the needs of the organisation in the future. Organisations need to focus on those factors that will enable long-term sustainable business performance, both internally and externally, that go beyond simply the financial metrics.

7. We do not think it is either possible or desirable to legislate for culture change, believing instead that this is more likely to be achieved through clear identification of best practice and non-statutory routes. It is important to give businesses "ownership" of the way they grow and implement their own cultures—a "one size fits all" approach is unlikely to work. Changing an organisation's culture fundamentally requires changes in leadership behaviours and cannot happen overnight, but it begins at the top and is reinforced through performance measures and reward practices. However, we believe that many of the measures recommended in the Kay Review, if implemented properly, will go some way to ensuring more company directors to take a longer term, sustainable view of their business activities.

8. On directors' pay, we believe that this should not only be dependent on long-term performance, but that performance measures themselves should include a wider range of considerations that go beyond the purely financial and how much profit is being generated. The vast majority of today's shareholdings are traded in very short-term cycles, which runs counter to the long-term view we are trying to encourage company directors to focus on. As well as generating profit, business leaders must show awareness of, and commitment to, longer-term stewardship responsibilities, as well as the leadership qualities required to take their workforce with them and drive sustained high performance. The measures used to determine pay of executives and the different reward components should be visible and open to external scrutiny.

9. Regarding narrative reporting, we have always been in favour of a more consistent standard of what is reported, where relevant and necessary information about the health and direction of the organisation not found in the statutory financial reports is given in a way that provides greater insight to all stakeholders. Today the significant majority of value of organisations is tied up in the so called intangible values—human and organisational capital, brand value etc. These are also the areas of value that are most critical to future performance, whereas traditional financial measures point to past performance.

10. We believe that now must be the time to better recognise the importance of human capital to organisational performance and to provide clearer direction and guidance on how information on the human capital of organisations is captured and reported. Previous initiatives such as the Accounting for People taskforce led by Denise Kingsmill in 2003 provided a good base to start from, but the prevailing economic times and political environment did not provide an impetus for take up. Many of the issues we are now confronting on encouraging the right cultures and behaviours, focusing on the issues and measures that really define longer term organisational performance and success have at their root the need to provide more visibility on the human capital and organisational dimensions of business. Providing a framework for reporting and comparing on these dimensions will be critical to providing insight to all stakeholders, including shareholders, and the pressure on management to focus on these longer term variables. This is something that the CIPD in combination with others such as CIMA and the UKCES are determined to make progress on, but will require sponsorship and support from Government.

11. Also crucial to a sustainable, long-term business strategy is investment in future talent pipelines, to ensure an organisation has the skills they need both immediately and for the future. In 2012, the CIPD launched its *Learning to Work* programme, aimed at achieving a shift in employer engagement with young people, so that they are encouraged to help them in entering and remaining in the labour market. As part of this, we encourage employers to adopt a “youth policy”, whereby they offer a wider range of entry routes into their organisations in order to be accessible to wider talent pools. This will not only contribute towards the important goal of driving social mobility, but will also help organisations develop the diverse and dynamic workforces they need to carry them into the future.

12. We welcome the actions taken by the Government following the publication of the final Kay report. We are strongly in favour of higher quality narrative reporting, incorporating strong guidance on human capital reporting, which is simpler and more relevant to its intended audience. In our response to the Department for Business, Innovation and Skills’ consultation on *The future of narrative reporting*, we called for the inclusion of human capital evaluation in company reports. We believe this to be crucial to long-term sustainability and performance because the practice of collecting, evaluating and reporting on these measures should enable better business decision-making for the long term. More generally, companies should be encouraged to be more long-term in their outlook. CIPD is also supportive of measures to remove mandatory quarterly reporting requirements also as a means to shift focus of measurement and incentive to longer term outcomes.

We will now turn to address some of the specific recommendations set out in the Kay Review, focusing on those on which our expertise enables us to comment most fully.

On whether the Stewardship Code should be developed to incorporate a more expansive form of stewardship, focusing on strategic issues as well as questions of corporate governance:

13. The revised UK Stewardship Code of September 2012 already includes strategy, corporate governance and culture within its definition of “stewardship activities”, on which institutional investors are encouraged to publicly disclose their activity with the aim of protecting value for their clients. It is also recommended that investors should consider intervening when they have concerns about the company’s strategy, governance and approach to risks, including those that are social or environmental.

14. However, we would encourage a *greater* focus on the aforementioned subjects in the Code, in recognition of the importance of culture and corporate governance to an organisation’s performance and brand. To date, there has been an insufficient demonstrated appreciation of the importance of issues such as management and leadership, employee engagement and workplace culture (and of corporate governance and culture more widely) amongst business leaders. Whilst we do not believe that culture change can be achieved through legislation, we believe that having clear guidance focused on good practice and outlining the business benefits to be gained from consistently demonstrating the right values in behaviours, communications and actions, will encourage directors and investors to ask more probing questions about a wider range of activities, both internally and externally.

15. A more expansive form of stewardship should entail a focus on employee engagement; we welcomed the launch of the Employee Engagement Taskforce by the Government in 2011 and the Engage For Success initiative in 2012, and will continue to support its aims of driving the value of employee engagement to business and financial performance. Company directors need to take a broader view of what is important, ensuring they operate with strong ethical principles, visibly demonstrating an awareness of the importance of long-term performance measures that go beyond the financial. Internally, starting from the top, directors must ensure they have channels and procedures in place to account for employee voice and challenge, as well as provisions for whistleblowing, to ensure that employees feel comfortable reporting wrongdoing.

16. We would like to stress that a Stewardship model may not be appropriate for all types of business—it might not work for a start-up, for instance. It would be unfortunate if one set of unintended consequences were replaced with another and we would warn the Government against pursuing this outcome too stringently as a “one size fits all” solution.

On whether company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making; and regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review’s Good Practice Statements:

17. We support the development of Good Practice Statements in principle. These will provide non-regulatory, non-binding guidance to company directors and investors on how organisations should be run for the benefit of their clients, employees and business. We favour a “comply or explain” approach to adherence to these statements rather than a hard regulatory approach.

18. The Good Practice Statements in John Kay’s Review rightly require asset managers and holders to operate in the best long-term interests of their client, operate within “a culture of open dialogue” and be transparent in their operations. The Statements also specify that remuneration should not be related to any short-term incentives of performance measures. We would recommend that these should be adopted and existing standards aligned to them.

19. However, we also believe that given the importance of human capital management (HCM) and reporting to the long-term business success of an organisation, this should be actively recommended in Good Practice Statements. Number 9 of the Review’s “Good Practice Statements for Asset Managers” recommends that asset managers be informed by “an understanding of company strategy and a range of information relevant to the specific company”. We believe that this could be developed, made clearer and more specific, in order to “nudge” companies to recognise the value of human capital reporting and act accordingly.

20. We believe that the HR function in particular has an important role to play in driving professional standards and best practice. CIPD is working with the City Values Forum, the Chartered Banker Institute and the City HR Association to promote professional standards in the City. Similarly, our own work as a Chartered institute encourages organisations to operate to a higher standard, incorporating performance against values and behaviours alongside the financial considerations. Within the past year, we have produced research insights into the importance of trust in the workplace, and the exploration of effective leadership models in the current political and economic climate. We have also worked with Business In The Community (BITC) on developing public reporting guidelines that take account of HCM data, and are actively seeking to collaborate more with bodies like CIMA to develop future-focused HCM guidelines.

On whether an investors’ forum should be established to facilitate collective engagement by investors in UK companies:

21. We believe that an investors’ forum would be a useful and valuable way for investors to share ideas and experiences, as well as discuss challenges as and when they arise. The opportunities for collective engagement that arise from information sharing in this way have the potential to be as useful as written public guidelines, and indeed would be complementary to them.

22. The existence of the City Values Forum and the Lord Mayor’s *Restoring trust in the City* initiative is evidence of a wider opinion that the current state of affairs does need to change and move towards a more inclusive understanding of purpose and performance. We encourage the Government to capitalise on this momentum and encourage greater collaboration with these and similar initiatives more widely.

Whether mandatory quarterly reporting obligations should be removed:

23. We support proposals to remove quarterly reporting obligations. We believe that this approach is consistent with the aim of fostering a longer-term approach to the evaluation of an organisation’s activities and performance. Reporting on a quarterly basis is not only quite burdensome for some companies, but may act as a contributory factor to a short-term outlook on company performance.

Whether high-quality, succinct narrative reporting should be strongly encouraged:

24. We are in favour of a high-quality, succinct approach to narrative reporting, with a strong focus on human capital management and other measures that support evaluation of the less tangible dimensions of sustained business performance. Good quality human capital information is crucial to informed decision-making, both internally and externally, in order to support sustainable organisation performance. We believe that the creation of a clear narrative reporting framework to help and encourage more employers to provide meaningful HCM reporting would be a useful step towards, over time, ensuring better-quality people management information is provided to shareholders.

25. HCM has historically been under-valued by investors, as has the importance of good management and leadership to organisational performance. CIPD’s 2006 research, *Investors’ view of human capital*, showed that even where human capital information was collected and analysed, this was too often focused too much on the top team, whilst data on the rest of the organisation was rarely used as the basis for investment decisions. Our

2010 report, *View from the City*, showed a refreshing positive change for the better in investors' views of HCM, but that the pace of change was slow. Crucially, however, there is evidence of stronger agreement around people management as a potential leading indicator of long-term business sustainability.

26. One of the difficulties inherent in using human capital data is that it does not translate easily into hard numbers and statistics, which investors typically feel most comfortable with. However, the increasing realisation that numerical data alone cannot give sufficient information for judgements to be made, and the need to be able to interpret hard data in the right context, may point to the increased use of more qualitative human capital data in recent years.

27. This, in turn, points to the argument that human capital data should be framed more in terms around HR and business risk, rather than in terms more related to social responsibility. Business leaders will inevitably be concerned about factors that stand to influence their productivity and overall profitability. If human capital data is presented in this kind of framework, it will encourage directors and investors to ask different questions about what factors stand to have positive (and negative) effects on their current performance and long-term sustainability.

28. We call on the Government to promote the use of HCM reporting by quoted companies on a voluntary basis. We believe that this position would be strengthened by the publication of good practice examples. Many companies already operate to high standards of narrative reporting, and shining a light onto best practice will clarify to others how high-quality reporting can be done. In response to what we believe to be the poor quality of reporting on HCM, CIPD with Henderson Global Investors supported BITC in producing public reporting guidelines in 2011, with the longer term aim of producing an accessible public reporting template for early 2013. We would be happy to share this with the Committee.

Whether companies should structure directors' remuneration to relate incentives to sustainable long-term business performance:

29. High executive pay and financial rewards for short-term successes (and sometimes failures) have become symptomatic of the destructive culture that pervades certain sectors, where a singular focus on financial gain has been allowed to predominate over consideration for how that growth is achieved. This has also led a tone to be set within certain organisations that encourages rule-bending and unnecessary risk-taking in pursuit of financial and other rewards.

30. Furthermore, this focus on financial gain to the exclusion of other considerations has played a large part in distorting views of businesses' purpose and role within society, resulting in the aforementioned decline in trust in big business. We believe that levels of senior pay should not only be related to longer-term performance measures, but that these performance measures themselves should account for a wider range of aims and objectives—going beyond the purely financial.

31. However, it is important to retain a degree of flexibility and perspective in this debate. In many instances, it would be entirely appropriate to reward short-term success, and we do not advocate that organisations should be dissuaded from doing so in all cases, rather that they should seek to base reward decisions on long-term performance measures and outcomes where possible.

32. We believe that organisations would benefit from clear guidelines (that are not prescriptive), as well as some examples of good practice on ways to manage reward-related risks. Evidence shows that many businesses can find the management of reward and reward risks quite challenging, which suggests the need for guidance that organisations can then tailor to their specific business models.

33. The CIPD's annual *Reward Risks* survey explores how organisations manage reward-related risks as perceived by practitioners and consultants, including strategic, implementation and governance risks. Our October 2012 report showed that the alignment of reward policy to wider business strategy remains as important, yet as nuanced and as challenging, to employers as in previous years. The overall top ten ranking of perceived reward risks include:

- Employees not understanding what is required of them in terms of behavior and performance.
- An inability to change reward practices quickly.

Difficulty communicating desired behaviour and performance requirements to employees.

34. The top concern for reward practitioners and consultants last year, as well as for 2011, was that employees did not appreciate the value of their total reward offering—perhaps unsurprisingly in the context of the communication difficulties many employers are experiencing. Employers also expressed concern that reward packages were not adequately engaging employees at all organisational levels. High pay has traditionally been cited as being necessary to keep “top talent” in an organisation. However, CIPD research, *Employee attitudes to pay*, shows that directors' pay, and the pay of other senior figures in an organisation, has the potential to affect levels of employee engagement and satisfaction lower down the organisation as well.

35. The idea that a reward package might not be seen as fair is another key concern for reward professionals and practitioners, featuring in our *Reward Risks* top ten ranked list of concerns for the past three years. Particularly during difficult financial times, the question of the distribution of pay throughout an organisation

will arise more frequently as lower-paid employees feel the pinch. The CIPD's *Employee attitudes to pay* report series examines employer pay decisions across the sectors and employee reactions to these. Our January 2013 report showed that many employees feel that senior managers and leaders are paid too much for what they do, whilst they themselves are undervalued by their organisation.

36. It is crucially important for organisations to acknowledge the importance of how their employees, as well as Boards and external stakeholders, are feeling about issues such as top-level pay and how it relates to their own remuneration. If employees believe that their employer is being inconsistent in their approach to remuneration at top and bottom, there is a real risk that this might cause disengagement with their jobs and their organisation, becoming less engaged with the collective endeavour. Organisations stand to suffer if their CEOs are not seen to regard themselves as stewards of the enterprise who are interested in long-term, sustainable success, and instead come across as being focused only on the short-term outlook, their career development and pay trajectory.

CONCLUDING COMMENTS

37. Notwithstanding the importance of financial considerations to businesses of all sizes, and the role of remuneration in recruiting and retaining talent, we see the greatest challenge following the Kay Review and the Committee's inquiry as that of widening perception beyond the realms of the financial, to take account of the importance of other factors that contribute to business success and sustainability.

38. The evidence, both from CIPD and other bodies, is that issues surrounding organisational and workplace culture, investment in skills and talent development, employee engagement, fair and open performance management and reward practices, and appropriate corporate governance, are what makes the difference to a business' long-term sustainable performance. The biggest issues are not only the financial considerations but how a company operates, whether it is seen externally to adhere to high ethical standards, and whether it demonstrates responsibility to both its internal and external stakeholders. The greatest contribution the Kay Review and the Committee can make to the future of UK business behaviour is to acknowledge this and to ensure that organisations themselves act accordingly.

22 January 2013

Written evidence submitted by UK Sustainable Investment and Finance Association (UKSIF)

SUMMARY

1. UKSIF welcomes the Committee's decision to conduct their inquiry; we are pleased to note that the issue of long-termism is attracting attention from a wide variety of industry, political and civil society stakeholders.

2. Our response focuses on: the role of asset owners and companies in boosting long-term investment; the need to integrate environmental and social (as well as governance) factors into decision-making; the role of the Government in ensuring stable regulatory and policy frameworks; and the importance of the Stewardship Code.

3. We agree with Professor Kay's analysis and conclusion that not only is short-termism a problem in UK equity markets, but that the principal causes are the "decline of trust and the misalignment of incentives throughout the equity investment chain".

4. This submission draws on feedback from discussions with our members and our previous submissions to the Kay Review, the Financial Reporting Council's consultation on proposed changes to the Stewardship Code (July 2012) and the Labour Party-commissioned Cox Review (August 2012).

ABOUT UKSIF

5. The UK Sustainable Investment and Finance Association (UKSIF) supports the UK finance sector to be a global leader in advancing sustainable development through financial services. We promote and support responsible investment and other forms of finance that advance sustainable economic development, enhance quality of life and safeguard the environment. We also seek to ensure that individual and institutional investors can reflect their values in their investments.

6. UKSIF was created in 1991 to bring together the different strands of sustainable and responsible finance nationally and to act as a focus and a voice for the industry. UKSIF's 250+ members and affiliates include pension funds, institutional and retail fund managers, banks, financial advisers, research providers, consultants and NGOs. For more information about UKSIF, please visit www.uksif.org.

THE KAY REVIEW

7. Responsible investors as a group have been among the first to consider the risks and opportunities from long-term social and environmental challenges. Leading practitioners have a particularly strong understanding of the market failures which sometimes prevent investors from translating this knowledge into investment decision-making.

8. We agree with Professor Kay's analysis of the shortcomings of the current structure of equity markets in promoting long-term decision-making, particularly the short-termist culture and practices across the investment chain and the underlying problems with trust and business relationships.

9. UKSIF also supports his approach to finding a solution to the problem of short-termism by setting out high-level principles to guide the regulation of equity markets. We particularly support his focus on defining and expanding the principles of stewardship.

10. We feel that both Professor Kay's analysis and his set of 10 guiding principles make an important contribution to the debate on long-termism; we hope that both Government and industry will take these principles forward.

11. We also believe that many of Professor Kay's recommendations could have a significant long-term impact on how shareholders engage with companies including:

- *Clarifying the concept of fiduciary duty*: Recent research has shown that in principle, long-term decision making is consistent with legal obligations but trustee concerns remain.
- *Encouraging high-quality, succinct narrative reporting*: We know from our members that investors require forward-looking business-relevant strategies and metrics, not simply boilerplate text. There are currently moves at a global level to support better-quality "integrated reporting" which supports value creation over time.
- *Improving the quality of engagement by investors with companies*: UKSIF members tell us that mandates, investment management agreements and scrutiny by asset owners are all effective tools in driving long-term approaches in the investment chain.
- *Restructuring directors' remuneration to relate incentives to sustainable long-term business performance*: We were pleased to see that BIS undertook consultations on narrative reporting and executive pay, in addition to commissioning the Kay Review. However, we still feel that the government has yet to facilitate a deep and constructive debate specifically on incentives and pay within the investment chain beyond these consultations.

12. Although we understand the need for any Government review to have a focused remit, we also feel that there were some areas relevant to encouraging long-term decision-making that we feel would have benefited from further examination.

The role of asset owners and companies in promoting long-term investment

13. The Kay Review Final Report focused largely on how to encourage asset managers to better think and act for the long-term as opposed to purely "managing short-term earnings expectations". While the role of intermediaries is important in promoting long-term investment, we believe it is not the whole story.

14. It is asset owners who are best positioned to drive change by incentivizing their managers to invest over a longer horizon than most currently do; genuine demand from pension funds and other asset owners could create commercial drivers for long-term investment practice and it has been a recurring theme amongst the feedback from our asset manager members that it is easier to justify effective implementation of, for instance, the Stewardship Code or the UN-backed Principles of Responsible Investment, if there is a commercial incentive to do so.

15. The need to boost asset owner demand for sustainable investment practices has also been highlighted by the Financial Reporting Council in their December 2012 publication *The impact and implementation of the UK Corporate Governance and Stewardship Codes*⁵⁹. Meanwhile, our most recent *Sustainable Pensions 2011* survey⁶⁰ found some excellent examples of best practice among pension funds but many more could do with following their lead.

16. We also feel that the Kay Review insufficiently examined the role of companies in encouraging "long-termism" in the investment chain through their influence on corporate pension funds, employees and other stakeholders. For instance, our *Sustainable Pensions 2011* survey suggested that plan sponsors would have influence if they encouraged their corporate pension funds to require long-term responsible investment approaches. We would also support an approach by companies to educate employees, customers and suppliers about the value of long-term investment practices.

17. In order to boost demand by asset owners and companies for long-term investment practices, UKSIF will be organising the UK's first "Ownership Day" on the 12 March 2013, a national campaign which aims to increase awareness and understanding of active long-term asset ownership and underline how it can protect the value of assets.

18. Our additional recommendations for Government include:

- *Ensuring that UK policymakers act as role models for responsible investment.*

⁵⁹ www.frc.org.uk/getattachment/47293b70-bd65-485c-bbcd-d9a63688b87d/Developments-in-Corporate-Governance-in-2012.aspx

⁶⁰ <http://uksif.org/wp-content/uploads/2012/10/UKSIF-Responsible-Business-Sustainable-Pension-2011.pdf>

- UK policymakers could act as leaders in responsible investment practices; for instance, the government could require all Local Government Pension Scheme funds to drive effective long-term approaches through their purchasing of investment services; Similarly, the UK Parliamentary Contributory Pension Fund (PCPF) could sign up to the Stewardship Code.
- *Improved co-ordination between The Pensions Regulator (TPR) and other regulators on the Stewardship Code.*

UKSIF have always believed that the Stewardship Code must harness the role of asset owner demand for good stewardship from their investment managers; we feel that there should be greater involvement by the TPR to encourage adoption of the Code throughout the investment chain.

ENSURING STABLE REGULATORY FRAMEWORKS THAT DRIVE LONG-TERM COMPETITIVENESS

19. We feel that there is a clear role for Government to play in ensuring that regulators and policymakers in or under the oversight of other departments in addition to BIS, such as the Treasury and the Department for Work and Pensions, act in a co-ordinated fashion to reform equity markets.

20. There is also a need for long-term policy stability when it comes to setting the framework for investment opportunities; Government policy has most potential to influence investors and corporate boards to focus on the long-term through its regulation of externalities—such as its policies on climate change. Unanticipated policy changes can damage investor confidence and their willingness to invest for the long-term.

THE GOVERNMENT RESPONSE

21. UKSIF welcomed the Government's response to the Kay Review Final Report and were pleased that it recognised the relevance of Professor Kay's analysis. We also welcome the Government's decision to organise a Progress Review for summer 2014 as we think this could be a promising signal of their commitment to driving forward Kay's recommendations.

22. We hope that there will be a move towards some form of cross-departmental work on stewardship including discussions with the Treasury as well as regulators like The Pensions Regulator and the FSA (and its successor bodies). We feel this would play an important part in spreading good stewardship practices across the investment chain.

Caroline Escott
Programme Director & Head of Government Relations
 22 January 2013

Written evidence submitted by Tomorrow's Company

ABOUT TOMORROW'S COMPANY

1.1 Tomorrow's Company is a London based global think tank delivering value for business leaders and owners by addressing the systemic questions of the business world through the overarching themes of: leadership and talent; sustainability and models of business success and governance and stewardship.

1.2 Our solutions are by business for business, built on deep relationships with business leaders, government, opinion formers and the media.

- Our work informs company law, creates international frameworks and shapes today's business landscape in the UK and globally.
- We defined the inclusive duties of directors for The UK's Company Act 2006.
- Our work on capital markets informed the creation of the UN PRI.
- Our thought leadership on ownership and asset classes is at the heart of the UK Stewardship Code.
- Our work on reporting is at the heart of Europe's move towards narrative reporting.
- King III in South Africa acknowledges our influence.

1.3 Tomorrow's Company has a long-standing relationship with BIS and has contributed to the reform of company law, the review of the combined code, the development of corporate reporting (including narrative reporting) and the creation of the stewardship code.

1.4 In March 2010, with the encouragement of and participation of BIS, Tomorrow's Company established the GGF, which brings together a number of key businesses, organisations and individuals to explore what good governance means and to make practical recommendations to company boards and policy makers. The forum is developing a series of guides and toolkits for use by chairs, boards and advisors, to help achieve practical improvement and change.

1.5 A meeting was held on in November 2011 with representatives from BIS, leading to a joint response by Tomorrow's Company and The Good Governance Forum was submitted to The Kay Review.

1.6 Tomorrow's Company welcomes this Committee's inquiry into the Kay Review of UK Equity Markets and Long-Term Decision Making and the Government's Response to that Review.

2 OUR RESPONSE

2.1 Tomorrow's Company welcomes the recommendations set out in the Kay Review and the Government's plans for the implementation of its recommendations, many of which Tomorrow's Company has argued for in its work.

2.2 In particular, we have been arguing that the financial crises are a result of a systemic failure—not only a failure of individuals and particular companies and institutions. Issues such as:

- investor short-termism;
- the stewardship deficit;
- the dysfunctional nature of the long investment chain (that links the saver at one end to the investee company at the other, a chain that is presently far too heavily influenced by intermediaries);
- the focus on quantity rather than quality of reporting;
- the current understanding and application of fiduciary duty;
- lack of alignment of incentives across the investment chain to the interests of beneficiaries; and
- all play their part.

2.3 It is therefore critical to understand the system as a whole and that any lasting solutions need to move beyond blame and a view that reform can be achieved by a series of piecemeal interventions.

2.4 Structural and process change is necessary but not sufficient to achieve change in the system. Culture and values both drive and inform behaviour across the system. In this respect we would highlight the work of The City Values Forum, supported by the Lord Mayor, aimed at enhancing the City's reputation for integrity and high ethical standards. As part of this initiative, Tomorrow's Company, in conjunction with the Good Governance Forum has been asked to undertake work on 'Governing Values' focused on the role of the board in overseeing the embedding of corporate values which are aligned to the business's long-term strategy, and in ensuring that management promotes and embeds such values consistently all the way through the business.

2.5 In support to the proposals of the Review's proposals, we would suggest the following.

2.6 STEWARDSHIP

- Stewardship is needed throughout the system—by pension trustees, investment consultants, asset managers, company directors, and regulation is needed to ensure all of the above are governed by consistently framed fiduciary duty.
- To assist we have developed four key principles of stewardship:
 - “Setting the course” deals with purpose, roles, and relationships.
 - “Driving performance” is about continually stimulating improved performance and capability.
 - “Sensing and shaping the landscape” is about how the company anticipates and influences change in its surrounding environment.
 - “Planting for the future” reflects the need for consistency between short-term actions and long term success.

(See: Tomorrow's Owners: Defining, differentiating and rewarding stewardship.
www.tomorrowscompany.com/tomorrows-owners-defining-differentiating-and-rewarding-stewardship
)

- These principles underpin the Tomorrow's Company Stewardship Manifesto which offers an agenda for change, and identifies the part that each participant can play in creating an effective stewardship value chain *See: Tomorrow's Company Stewardship Manifesto*
www.tomorrowscompany.com/stewardship-manifesto)
- As part of the Investor Stewardship Working Party, we have developed a 'stewardship framework' against which institutional investors can categorise themselves to help asset owners compare the stewardship activities of different fund managers and so make informed decisions. (*See: 2020 Stewardship: improving the quality of investor stewardship*
www.tomorrowscompany.com/2020-stewardship-improving-the-quality-of-investor-stewardship-the-report)

2.7 GOVERNANCE

- Boards to be more confident in ensuring that they are crystal clear about their own long-term view as the best way of achieving success and managing risk in these conditions of rapid change and growing uncertainty—and then setting out their strategy and communicating this effectively to investors. They should actively seek out the investors that they want. To assist them in doing this, Tomorrow's Company and the Good Governance Forum argue that boards should create a board mandate. This mandate captures the “essence” of the “character” and distinctiveness of the company, in terms of: its essential purpose; its aspirations; the values by which it intends to operate; its attitude to integrity, risk, safety and the environment; its culture; its value proposition to investors; and plans for development. It is about what the company stands for and how it wishes to be known to all of its stakeholders.

(See: Tomorrow's Corporate Governance: The case for the “board mandate”

www.tomorrowscompany.com/tomorrows-corporate-governance-the-case-for-the-board-mandate)

- Corporate reporting plays an essential role in the effective functioning of the market economy, enabling shareholders and investors to assess the performance of a business across all aspects of activity, establish its value and exercise effective oversight. Whilst there are many regulatory and market initiatives and consultations in various parts of the world focused on different aspects of reporting and of the reporting system there is a danger of overload. While these consultations are all well-intentioned, the very fact they are addressing separate elements of the model and the system is indicative on a lack of understanding of how the system operates, its interdependencies, and most critically, how proposed actions will impact on behaviours. The proposals for narrative reporting—which we strongly welcome and have long argued for—need to be framed in a context which reinforces this coherence of approach by recognising the systemic nature of the corporate reporting system and the place of the specific reform in that wider context.

(See: Tomorrow's Corporate Reporting: a critical system at risk www.tomorrowscompany.com/tomorrows-corporate-reporting-a-critical-system-at-risk-2)

2.8 INCENTIVES

- There is a lack of alignment between incentives, the interests of beneficiaries and business strategy. The criteria on which performance and hence reward is based are still too often founded on financial and market value based measures. In part this is a reflection of the lack of knowledge, understanding, common language and metrics about what drives sustainable performance. Discussions about sustainability often default to ESG, SRI, the “green agenda” or are simplified to discussions about long-term versus the short-term horizons.
- For outsiders, it is hard to obtain detailed information on how incentives are structured and designed—there is a lack of transparency. Financial incentives do not operate in isolation—neither are they the only incentives for those in the system. Reputation, personal success and security, organisational values and culture, regulation, fiscal policy and reporting models, all play their part.
- In our work on Tomorrow's Capital Markets, we found that there is a growing appetite for change by many who have deep and long experience of working in the system. We have set out an agenda for change, encompassing a set of principles for the structure of financial remuneration so that capital markets can better support companies to achieve more sustainable outcomes. We are in the course of developing a follow-up phase which will focus on designing new incentive structures as well as looking at what is needed to create the necessary framework conditions for these incentives to operate effectively and also to ensure greater stability of the system as a whole.

(See: Tomorrow's Capital Markets

www.tomorrowscompany.com/tomorrows-capital-markets-2)

2.9 REGULATION

- In our current project: “Tomorrow's Value: Achieving sustainable financial returns” we are exploring how we can redefine value in order to ensure sustainable financial returns and a more balanced approach to investment. This includes understanding the behavioural pressures and fiduciary issues which can lead short-term thinking and investment decisions by pension fund trustees and aims to provide them with fit for purpose evidence and some practical support.
- Our research to date endorses the view that fiduciary duty is not well understood by pension fund trustees and needs to be appropriately and more widely interpreted. Trustees can then feel more confident in implanting their wider views of value into their investment mandates, allowing for a more risk adjusted investment portfolio and sustainable financial returns.
- As behavioural pressures on the pension fund trustees are numerous, systemic and powerful, a better understanding may not be enough.
- Following consultation with a number of key players in the UK pension fund system and across Europe, the case can be made for strengthening the Statement of Investment Principles, through an appropriate intervention to encourage and support pension fund trustees in setting out on a comply or explain basis the criteria that inform the mandate that they set.

To conclude, we welcome the Committee's inquiry into the Kay Review of UK Equity Markets and Long-Term Decision Making and the Government's Response to that Review and also welcome many of the proposals outlined. Our major disagreement with the Kay Report lies in its excessive focus of on the role of the asset manager at the expense of the asset owner. The key point is that this complex system can only be reset with asset owners playing the role that they are required to play.

We would be happy to discuss any of the aspects of our response in more detail.

22 January 2013

Written evidence submitted by the Investment Management Association⁶¹

EXECUTIVE SUMMARY

ES.1. The asset management industry plays a vital role in allocating capital from those that want to invest to those that need investment capital. This is important to the achievement of the Review's vision in creating growth and jobs, and whilst much is said about the loss of trust in the intermediation of the markets, the UK asset management industry remains strong. It saw a 5.1% increase in assets under management in the year to December 2011 from 2010, and 23% from 2009⁶².

ES.2 As an agent, an asset manager has a fiduciary responsibility to its clients, as well as responsibilities derived both from contractual agreement and regulation. Combined with fee structures, these elements help to ensure that the manager acts in the client's best interest. In this context, IMA supports stewardship—it is important for ensuring good outcomes for clients. Our members are increasingly pursuing good corporate stewardship in achieving better outcomes. However, an asset manager acts as an agent for its clients and we do not support such matters being prescribed such that the terms of asset owners' mandates with managers are constrained. Moreover, while long-term holdings will tend to form a core part of portfolios, holding periods for individual stocks and securities will inevitably vary. The important thing is that asset managers continue to deliver value for their clients. Nor do we consider an asset owner should be ascribed a societal role in determining the terms of their mandate.

ES.3 We set out below our evidence on Kay's Recommendations and the Government's Response. In places we distinguish between "fund managers" operating pooled funds such as UK Authorised Funds (unit trusts and open-ended investment companies) which pool money from many clients in the same vehicle; and "investment managers" that have discretionary management of assets for individual clients according to segregated mandates. We refer to the two together as "asset managers".

Recommendation 1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance

1.1 IMA supports this Recommendation and, as noted in the Government's response, it has already been addressed in the Financial Reporting Council's revised edition of the Stewardship Code which was published in September 2012 and came into effect on 1 October 2012.

1.2 Over the last three years, with a steering group chaired by the FRC, IMA has looked at institutional investors' activities that underlie their policy statements drawn up under the Code. Our first report looked at the position as at 30 September 2010⁶³, our second to 30 September 2011⁶⁴ and we plan to issue our third to 30 September 2012 in the first part of this year.

1.3 The second report summarised 83 responses to a questionnaire sent to 173 signatories as at 30 September 2011. The 58 asset managers that responded managed £774 billion of UK equities, representing 40% of the UK market, and the 20 asset owners owned £62 billion (five Service Providers also responded but do not manage or own equities for investment purposes).

1.4 To gain a better understanding of the issues that give rise to engagement, respondents were invited to indicate the number of companies they engaged with on particular issues. This demonstrated that a company's strategy and objectives are clear priorities in that respondents engaged with 1,611 companies on these issues. This compares to more conventional corporate governance matters and engagement with 1,754 companies on remuneration issues (these are subject to a specific vote) and 1,039 companies on board diversity/committee membership. A similar ranking is evidenced in the third draft report which is still being collated.

⁶¹ IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of approximately £4.2 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (eg pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, the Annual IMA Asset Management Survey shows that IMA members managed holdings amounting to 34% of the domestic equity market.

⁶² Page 14, Asset Management in the UK 2011–2012, the IMA Annual Survey. <http://www.investmentfunds.org.uk/research/ima-annual-industry-survey/>

⁶³ <http://www.investmentfunds.org.uk/research/stewardship-survey>

⁶⁴ <http://www.investmentfunds.org.uk/assets/files/surveys/20120612-stewardshipcode.pdf>

1.5 Moreover, in seeking to establish a mechanism for collective engagement (see press release at <http://www.investmentfunds.org.uk/press-centre/2012/press-release-2012-11-22>) one of our premises is that intelligent engagement with companies on strategy can help secure better long-term sustainable returns for shareholders. Governance and remuneration issues are important in so far as they underpin the achievement of that strategy (see Recommendation 3 below).

Recommendation 2. Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements

2.1 IMA supports market-led solutions and in principle, the proposed Good Practice Statements for asset managers, asset owners and company directors seeking to emphasise the need for trust-based relationships.

2.2 However, many of the points in the proposed Good Practice Statement for asset managers are already addressed in regulation. For example, all regulated firms are subject to the Financial Services Authority's "11 Principles" which include requirements to:

- conduct business with integrity, and due skill, care and diligence;
- pay due regard to clients' interests and treat them fairly;
- pay due regard to clients' information needs and communicate information which is clear, fair and not misleading;
- manage conflicts of interest fairly, both between the firm and its clients, and between individual clients; and
- take reasonable care to ensure the suitability of advice and discretionary decisions for any client that is entitled to rely on the firm's judgment.

It is also a European requirement, first implemented in the FSA Handbook from 1 November 2007, that asset managers must act honestly, fairly and professionally in accordance with the best interests of their clients (and now in the case of a fund manager, the fund it manages). These requirements largely address the first three points in the Statement.

2.3 Other rules provide greater specificity in particular areas. For example, as regards "adhering to the investment strategy agreed with clients",⁶⁵ suitability requirements⁶⁶ seek to ensure an asset manager obtains information to understand the essential facts about their client and has a reasonable basis for believing that transactions in the course of managing that client's assets meets the client's objectives.

2.4 Specifically, the information on a client's objectives must include, where relevant, the length of time the client wishes to hold the investment, their attitude to risk and risk profile, and the purpose of the investment. A client's, the asset owner's, time horizons, investment objectives and strategy may vary. Thus an asset manager may not be able necessarily to prioritise "medium to long-term value creation and absolute returns"⁶⁷ and make "investment decisions based on judgments about long-term company performance".⁶⁸ It is not a given, for example, that an asset owner wants an absolute return investment objective.

2.5 Similarly as regards asset managers building an "on-going relationship of stewardship with the companies they invest",⁶⁹ it is an FSA Conduct of Business requirement that asset managers (with professional clients) have a statement of their commitment to the FRC's Stewardship Code or explain their alternative strategy.⁷⁰ This, and the "comply or explain" approach to the Code itself, recognises the agency nature of asset management and that as fiduciaries acting on behalf of clients, managers offer a choice. In operating in the best interests of its clients, see 2.2 above, an asset manager may want to divest a holding if clients' interests cannot be protected through stewardship and we are concerned that it is often implied that asset owners and managers have a societal role that requires them to engage with companies.

2.6 Moreover, both long-term value creation and stewardship are more immediately relevant to equity markets. Both asset managers and asset owners will have market exposures far wider than equities and which are international.

⁶⁵ Point 6 in the Good Practice Statement.

⁶⁶ Financial Services Authority Conduct of Business Rule 9.2.1, (1) firm must take reasonable steps to ensure that a personal recommendation, or a decision to trade, is suitable for its client. (2) When making the personal recommendation or managing his investments, the firm must obtain the necessary information regarding the client's: (a) knowledge and experience in the investment field relevant to the specific type of designated investment or service; (b) financial situation; and (c) investment objectives; so as to enable the firm to make the recommendation, or take the decision, which is suitable for him.

⁶⁷ Point 7 in the Good Practice Statement.

⁶⁸ Point 9 in the Good Practice Statement.

⁶⁹ Point 8 in the Good Practice Statement.

⁷⁰ Financial Services Authority Conduct of Business Rule 2.2.3 which was effective from 6 December 2010. This requires that an asset manager acting for a professional client that is not a natural person must disclose clearly on its website, or if it does not have a website in another accessible form: (1) the nature of its commitment to the Financial Reporting Council's Stewardship Code; or (2) where it does not commit to the Code, its alternative investment strategy.

2.7 Care, therefore, is needed to place Good Practice Statements⁷¹ into their appropriate context and in ensuring that they are not unduly constraining for asset owners and asset managers, and the terms of any agreed mandate. Notwithstanding this, IMA has been a long-standing supporter of the stewardship agenda and our members are increasingly pursuing considered corporate stewardship in achieving better outcomes for clients. We set out in Annex 1 how this role has been transformed over the last decade. We are also a member of the Institute of Chartered Secretaries and Administrator's steering group referred to in the Government's response.⁷² This is developing a good practice guide to improve the quality of engagement and aims to identify more effective means for companies and institutional investors to provide feedback on meetings.

Recommendation 3. An investors' forum should be established to facilitate collective engagement by investors in UK companies.

3.1 IMA agrees that it may be helpful to establish an investor forum or mechanism to facilitate collective engagement. Whilst we recognise there are already a number of ways in which groups of investors come together, we believe there may be a need for a mechanism, which is open to the broadest possible range of shareholders in a particular company to take collective action, in instances when individual engagement has failed. We believe it important that any such initiative is investor/shareholder led and are currently engaging with the investment community in completing a series of meetings in order to determine the best means of taking this forward. We are also keeping BIS officials up-to-date with developments.

3.2 Whilst we have certain ideas, we want an open discussion in order to be able to develop a solution that will be effective and which is supported—see Annex 2. We believe that any solution should elevate the importance of investor understanding and engagement with a company's strategy for the delivery of sustainable, long-term shareholder value. Wider governance and remuneration issues are important in so far they underpin the achievement of that strategy. Some of the issues that have been identified to date during our discussions include:

- any mechanism to be effective needs to ensure, either through a Code of Conduct and/or Non-Disclosure Agreements, that discussions are kept confidential;
- concerns about the creation of price sensitive information with the concomitant trading restrictions need to be addressed; and
- concert party concerns which appear particularly to be an issue for US investors.

3.3 As noted, we want any such mechanism to be investor-led, but, if sufficient support can be secured, we are committed to providing it with resource and funds as necessary. We are discussing our proposals with other trade associations, such as the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF), and are including them in our meetings with investors and keeping them up-to-date with our thinking as it develops.

Recommendation 4. The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves

4.1 This is outside IMA's remit.

Recommendation 5. Companies should consult their major long-term investors over major board appointments

5.1 In principle, IMA agrees that companies should consult their major investors over major board appointments. In the main this already happens and investors welcome it particularly when a company is considering changes at a time when the company concerned is in difficulty or to key roles such as chairman or chief executive. But we do not believe investors or companies necessarily want to be consulted on every appointment or that this should be mandatory—neither has the resource to do so and it could undermine the role played by the nominations committee. We also question what is meant by “long-term” investors. Asset managers provide their clients with an investment service and adopt varying strategies to meet specific mandates. While long-term holdings will tend to form a core part of portfolios, holding periods for individual stocks and securities will inevitably vary.

5.2 In the event a company makes an appointment that investors do not believe is appropriate, each new appointment has to be ratified at the Annual General Meeting and it is a provision of the UK Corporate Governance Code that all directors of FTSE 350 companies are subject to annual re-election by shareholders.⁷³

5.3 Moreover, when signatories to the Stewardship Code indicated the number of companies they engaged with on particular issues, see paragraph 1.4 above, executive remuneration and company strategy/objectives, were closely followed by board diversity/committee membership (1,039 companies).

⁷¹ Points 4, 5, 10 and 11 in the Good Practice Statement repeat Recommendations 8, 10, 3 and 16, respectively. Our observations are set out under the relevant Recommendation.

⁷² Page 19.

⁷³ Provision B.7.1. B.7.1 and B.7.2 also expect the papers accompanying a resolution to elect or re-elect directors to set out the following: sufficient biographical details to enable shareholders to take an informed decision; why they believe an individual should be elected; and on re-election confirmation that, following formal performance evaluation, the individual's performance continues to be effective and demonstrates commitment.

Recommendation 6. Companies should seek to disengage from the process of managing short term earnings expectations and announcements

6.1 As set out under Recommendations 11 and 15, quarterly reporting and executive remuneration structures, respectively, can result in too much focus on the short-term meaning that companies can lose sight of their long-term objectives for development of the business and can result in value destruction. We consider these matters should be addressed.

Recommendation 7. Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.

7.1 We do not consider the proposed new standard is needed given existing regulation (of which much is at EU level). We set out at Annex 3 our paper on the relationship between fiduciary duty, contract and regulation that we submitted to Government (this addresses segregated mandates). As we explain in this paper and our submissions to the Kay Review, we do not consider that existing regulation acts as an impediment to asset managers using a long-term approach where the client expresses such an objective.

7.2 Even if there could be a restatement of fiduciary obligations consistent with EU law, IMA considers that the current rules impose very high standards. It is still unclear to us what is deficient with the current requirements for asset managers; if trustees are fearful of suit or the law applying to them is unclear, then that is a different issue. The investment manager's role is to follow the mandate it is given by the client; the fund manager to follow the objectives of the fund prospectus.

7.3 We do not see the need for the UK to move away from the EU standard, even if it could make a case to do so. Additionally, and without prejudging any Law Commission work—see Recommendation 9 below—we do not consider it would be sensible from the viewpoint of the UK's competitiveness to prohibit contractual modification of a range of, sometimes disputed, statements of fiduciary responsibility, developed through case law in many areas of business. It is essential that services can be tailored to the needs of global investors serviced from the UK, especially where the investor concerned has no interest in UK equity investment. Annex 3 explains our position.

Recommendation 8. Asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund

8.1 The asset management industry is committed both to high standards and consistency of disclosure. Detailed parameters for disclosure by investment and fund managers of charges for services (including performance fees) and transaction costs incurred in delivering those services are set out in both regulatory requirements and industry codes and guidance. We set out below the requirements for investment managers' segregated mandates and fund managers' pooled funds.

SEGREGATED MANDATES

8.2 Disclosure to one of the most significant client groups using segregated mandates, occupational pension schemes, is covered by the IMA's Pension Fund Disclosure Code. This was first produced in 2002 by a group of investment managers, pension fund trustees and investment consultants, and has been endorsed by the NAPF's Investment Council.

8.3 The Code's objective is to promote investment managers' accountability to clients through increased transparency and to assist pension fund trustees' understanding of the charges and costs levied on the fund's assets for which they are responsible. It provides a comprehensive, clear and standardised form of disclosure that allows trustees and their advisers to monitor and compare all costs incurred during the management of their fund's assets.

8.4 The Code has been updated twice, in 2005 and 2007, to accommodate disclosure requirements under the FSA's Use of Dealing Commission regime, and also to bring it into compliance with the execution provisions of the Market in Financial Instruments Directive 2004/39/EC (MiFID). It operates on two levels.

- Level 1 is a description of house policies, processes and procedures in relation to the management of costs incurred on behalf of clients and, in respect of new provisions brought in by MiFID, appropriate information on the investment manager's execution policy. This is particularly relevant for the disclosure of implicit costs where they cannot be measured accurately eg transaction costs.
- Level 2 is client specific information. This requires disaggregation of transactions by counterparties and disclosure of commissions on those transactions and services received in exchange for those commissions. Additional commentary is provided where this helps put numerical disclosure into context. It also requires managers to disclose, in percentage terms, the firm-wide pattern of trading, and the sources and uses of commissions overall in the relevant asset class and to compare that to the specific client.

In addition, Level 2 requires disclosure of other costs eg fund management fees and other income derived by the manager and associates, underwriting/sub-underwriting commissions, stock-lending income to the fund and the associated fees, VAT, stamp duty and any other transaction taxes and levies.

8.5 The latest version of the Code is at: *Pension Fund Disclosure Code—September 2007*.

POOLED FUNDS

8.6 A version of the Pension Fund Disclosure Code applies to pooled funds that are UK Authorised Funds. This is the CIS Disclosure Code, jointly issued by the IMA and the Depositary and Trustee Association (DATA), and is intended to provide a similar level of accountability and transparency with respect to transaction costs to that provided by the Pension Fund Disclosure Code. However, the CIS Code is not a consumer document, but intended to be used by fund trustees and depositaries with specific oversight responsibility for Authorised Funds. It is available on request.

8.7 The majority (around 85% of total funds under management) of UK Authorised Funds are regulated under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directives. These are governed by the Key Investor Information Document (KIID), which ensures that charges (including performance fees) are disclosed in a transparent and consistent manner. The KIID does not cover transaction costs, which have traditionally been disclosed in a fund's report and accounts which are available to all investors. However, IMA considers that for retail investors in particular, there is a need to make transaction costs more accessible. After consultation, IMA issued Enhanced Disclosure Guidance in September 2012, which both addresses the accessibility of transaction cost data and aims to achieve greater consistency in charge disclosure. The latest version is at: *Enhanced Disclosure Guidance*. IMA is also supporting work in the pensions industry seeking to develop greater consistency of disclosure both for workplace scheme decision-makers and for consumers.⁷⁴

8.8 Some have suggested that charges and transaction costs should be combined into a single number. IMA strongly disagrees with this and believes a single metric would be misleading since charges and costs are fundamentally different and behave in different ways. Charges are paid for a service undertaken on behalf of an investor. Transaction costs (including taxes such as stamp duty) are necessarily incurred in the management of the portfolio in delivering the investment objectives. They are not paid to a manager, but arise when buying and selling investments in the market.

8.9 For example, take two equity funds—Fund A has an on-going charge of 0.5% and turns over 10% of its portfolio during a one year period. Fund B has an on-going charge of 0.5% and turns over a quarter of its portfolio over the same period. Which is more expensive? In reality, both charge the same for the service, but only the performance will tell you whether the transaction costs had a positive result on the final outcome. A manager cannot hide from poor performance and a poorly performing fund manager will receive lower income via ad valorem charges—there is no incentive to over-trade to the detriment of performance.

8.10 In summary, IMA believes that both charge and transaction cost information should be readily available to investors to help them understand what they paying a manager and the manager's costs in providing that service. Combining figures would not be meaningful.

Recommendation 9. The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers

9.1 Asking the Law Commission to undertake such a review will mean that it will be subject to an open and transparent consultation process. We welcome this approach and the opportunity to provide input. In this respect, the Law Commission undertook sound work on fiduciary duties in financial services in the mid-1990s.

Recommendation 10. All income from stock lending should be disclosed and rebated to investors

10.1 Stock lending generates incremental returns for portfolios contributing to the overall investment performance. IMA supports consistent transparency of stock lending and the associated income to end-investors so that they have a clear view of the revenue earned and the amount retained by the lending agent. Indeed, in 2005, IMA introduced accounting requirements under which managers of UK Authorised Funds were required to disclose the gross amount of fee revenue generated from stock lending, in addition to the amount received by the fund, the value of stock on loan and the nature and value of collateral held as security. However, we do not agree that all income should always be rebated.

10.2 Stock lending seeks to minimise the potential risks to the end-investors in that multiple counterparties are used, there is over collateralisation and contractual indemnification against losses from borrower default. These activities come with a cost to the lending agent—counterparties and collateral parameters are continuously reviewed, and settlement and corporate actions monitored. The lending agent provides trading expertise, economies of scale and risk controls across all clients that lend their stock. Moreover, whilst a high

⁷⁴ This work has involved both the NAPF, which has now published a joint industry code on disclosure to employers, and the ABI, which is currently considering how to improve consumer disclosure.

proportion of stock lending is through automated programmes, these require significant investment in systems and technology.

10.3 The model established by end-investors and the stock lending industry is that the lending agent receives a percentage of gross revenues to cover the costs of the service. The agent is only compensated if revenue is generated and thus the end-investors' interests are aligned with those of the lending agent.

10.4 UK Authorised Funds have been permitted to conduct stock lending only on the basis it represents no or minimum risks for investors in these funds. This risk to end-investors is minimised by Regulation which requires full collateralisation of exposures with highly liquid assets.

Recommendation 11. Mandatory IMS (quarterly reporting) obligations should be removed.

11.1 IMA supports this Recommendation and the fact that the existing EU requirement for interim management statements is being removed. There is a broad consensus in the UK that the re-introduction of a quarterly reporting requirement would be unhelpful on the basis that it can incline companies to focus on the short term.

Recommendation 12. High quality, succinct narrative reporting should be strongly encouraged.

12.1 IMA supports this Recommendation. Investors are increasingly concerned about the length, clarity and focus of annual reports in that reporting has become increasingly complex. In particular, the narrative information in the "front half" of an Annual Report and Accounts could be presented more clearly and the accounts as whole could be more cohesive. For too many organisations, reporting is seen as a legal compliance process, rather than as a process for communicating what matters. This shopping list approach makes it more difficult for companies to deliver real strategic thinking and close the gap between the transparency provided by those companies that genuinely think long-term and those that do not.

12.2 Investors want material strategic issues disclosed not the issues per se. We support Government's proposals in this area⁷⁵ and the FRC's current discussion paper "Thinking about financial reporting disclosures in a broader context".⁷⁶ However, in general IMA believes the detail of narrative reports is best developed by market practitioners, the preparers and users of the information. This is a role that could be fulfilled by the FRC's Financial Reporting Lab which aims to provide an environment where investors and companies can come together to develop pragmatic solutions to today's reporting needs.

Recommendation 13. The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations

Recommendation 14. Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment

13.1 As regards, Recommendations 13 and 14, the asset management industry is varied and models and metrics develop. We consider regulators, including for IMA members the Financial Conduct Authority, are well placed to conduct thematic reviews of such matters and are bound to have noted and be considering these Recommendations. In this context, some of our members are concerned about the tendency of regulators to prescribe "one size fits all" and require substantive evidence. Nor do we believe Government would necessarily be the appropriate body for such specialised and interactive work.

Recommendation 15. Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business

15.1 Incentive structures for executive directors in the listed sector are an important driver of behaviours and in principle, IMA supports this Recommendation. Investors want companies to have remuneration policies that are aligned with their interests such that they promote long-term value creation, take account of the fact that effecting change to a company's strategy takes time, and mirror a company's development cycle.

15.2 Too frequently remuneration structures are based on short-term earnings and share price. Even long-term incentive plans (LTIPs) rarely extend beyond three years. Also, benchmarking executive remuneration to the size of the business creates a motive to acquire businesses to boost directors' earnings. There are a number of examples of acquisitions which in the long-run destroyed value. The short tenure of certain executives can compound this in that it is often not long enough to see the rewards from an investment. Certain authors have argued that a focus on earnings has given wrong incentives to management and that alternative metrics should be considered⁷⁷.

15.3 We welcome the improvements that Government is making in improving transparency so that a company's future pay policy is clear and easily understood, and that there is a clearer link between pay and a

⁷⁵ Page 6 of the Government's response.

⁷⁶ <http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/October/FRC-publishes-paper-to-enhance-disclosure-in-finan.aspx>

⁷⁷ https://secure.cfauk.org/assets/2162/CFAUKDBIS_Long_Term_responseSENT.pdf

company's strategic objectives and performance. The policy report is to look forward and be subject to a triennial binding vote unless the policy changes. The implementation report looks back on how the policy was effected in practice and is to be subject to an annual advisory vote.

15.4 Undoubtedly the time horizons over which management is incentivised need to be addressed. However, our preference would be for the Recommendation to set out the principles that should underlie any long-term incentive plans rather than prescribe they should be by way of shares—shares are an effective way to incentivise long term performance, but are not the only way. Moreover, requiring executives to hold the shares until after they have retired could result in them leaving a company when they consider it the best time to realise those shares. Certain of our members consider that a suitable compromise between career shares and the current standard practise for three year LTIPs would be five year LTIPs. There need not necessarily be a five year vesting period but at a minimum, there should be a period of at least five years between the date of grant of the award and any sale of shares. However, in general we believe, the Government's changes should be given time to take effect before further measures are considered.

Recommendation 16. Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund

16.1 If asset managers are listed they are subject to the same requirements as the listed sector. In any event they are regulated entities supervised by FSA. The FSA has set out clear principles in its Remuneration Code, which derives from European legislation. It applies to investment managers regulated under MiFID and is to be extended to fund managers under UCITS and AIFMD. European law requires firms to apply "remuneration policies, practices and procedures that are consistent with and promote effective risk management". Thus remuneration has to be aligned with the risks of the firm and Code Staff pay has to be disclosed. We do not believe there is a case for further regulation.

16.2 Specifically an individual portfolio manager's performance may commonly be assessed on a medium to long-term basis, with other factors such as client satisfaction, attitude to risk, and the extent to which the employee is a team player taken into account. For example, for an individual fund managers' remuneration, the basic/fixed part is around 30 to 40% of the total and the performance part is around 60 to 70%, of which a significant amount is deferred over two to four years. As well as bonuses being deferred they are also subject to claw back arrangements where targets are not met. To quote various asset managers:

- "[Our] remuneration policy is team based and 75–80% of bonuses is paid in shares and has a three year vesting period. There is therefore no incentive to focus on one year's performance."
- "[We] are increasingly charging performance fees, which are based on at least a year-on-year performance. Remuneration of individual fund managers is based on a mix of team, fund and individual performance (roughly a third each) and no changes have recently been made to this policy."
- "There is no linkage with fees and short termism if they are calculated on an ad valorem basis. [It] does have some funds with performance fees which are calculated each year. Where there has been some underperformance however the fund has to get back to its starting position before any subsequent outperformance can be rewarded. [It] believes this aligns them with the client and as they are building a long term relationship does not lead to taking risks in the short term."
- "[We] have no remuneration structures whether for managers or the company, which incentivize an increased turnover of securities."
- "[Our] individual asset managers have their remuneration linked to 1 and 3 year performance cycles."

16.3 While the level of fees has an impact on performance, individuals are paid by the firm, not by the client, so that decisions about an individual's remuneration do not affect the cost to clients. In any event, due to the way the industry is remunerated asset managers', companies' and clients' interests are aligned. The better the company does, the better clients and asset managers do. Whilst providing a performance incentive in the form of an interest in the fund to be held at least until the portfolio manager is no longer responsible for that fund may be conceptually attractive, it could encourage a portfolio manager to leave at a time when their particular fund is performing well for clients and in many asset managers, it is not an individual portfolio manager that is responsible for a particular fund.

Recommendation 17. The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.

17.1 Whilst we would welcome Government exploring the cost of intermediation to investors so that they can hold shares directly on an electronic register, this matter is being looked at as part of the proposed EU Securities Law Directive.

STEWARDSHIP

IMA has been a long-standing supporter of the stewardship agenda. We firmly believe many clients of asset managers expect stewardship responsibilities to be taken seriously when delegated to the manager, and those managers should and do respond to this.

It is also clear that this stewardship role has been transformed in the last decade. In 2002, investors gave new impetus to stewardship and the Institutional Shareholders' Committee (ISC⁷⁸), whose members, including IMA, represent virtually all UK institutional investors, issued the Statement of Principles.⁷⁹ This was the first comprehensive statement of best practice governing the responsibilities of institutional investors in relation to the companies in which they invest on behalf of the ultimate owners.

IMA benchmarked the industry's adherence to the Statement of Principles through regular surveys. Starting in 2003, these clearly demonstrated that engagement was evolving and becoming more transparent. The last survey to 30 June 2008 showed that 32 asset managers that managed equities amounting to 32% of the UK market actively engaged, voted their UK shares, and increasingly published their votes⁸⁰.

Nevertheless, institutional investors recognised that in the run up to the financial crisis there were failings in their scrutiny and challenge to banks' strategy and excesses, and that they needed to address this. The ISC took steps to do so and reissued the Statement of Principles as a Code in November 2009, modifying it to seek to improve the dialogue between institutional investors and companies.

The Government at the time wrote to the FRC asking it to adopt the Code and, following a public consultation, the FRC issued it as the Stewardship Code in July 2010. In December 2010, the FSA made it a requirement that authorised asset managers disclose publicly their commitment to the Code or their alternative business model. This aimed to ensure that those that appoint asset managers are aware of how a manager exercises its stewardship responsibilities, if any. The Code also expects those that commit to it to report to their clients/beneficiaries on how they have exercised their responsibilities and to have a public policy on voting disclosure.

It is important that this transparency is supported by practice. Over the last three years, under the direction of the FRC, IMA has looked at institutional investors' activities that underlie their policy statements drawn up under the Code. Our first report looked at the position as at 30 September 2010,⁸¹ our second to 30 September 2011⁸² and we plan to issue our third to 30 September 2012 in the first part of this year.

The second report summarised 83 responses to a questionnaire sent to 173 signatories as at 30 September 2011. The 58 Managers that responded managed £774 billion of UK equities, representing 40% of the UK market, and the 20 Asset Owners owned £62 billion (five Service Providers also responded but do not manage or own equities for investment purposes).

The report clearly demonstrated progress. For example:

- as at 30 September 2011 173 institutional investors had committed to the Code up from 80 as at 30 September 2010;
- all of the 2011 respondents now have complete policy statements on how they exercise their stewardship responsibilities whereas in 2010, six respondents only had a statement of their intention to produce one;
- in 2011, more of the 2010 respondents have client mandates that refer to stewardship;
- the 2010 respondents increased their resources responsible for stewardship by 4% in 2011;
- the proportion of votes cast increased in all markets in 2011; and
- a greater proportion of respondents publicly disclose their voting records—73.4% in 2011 as compared to 69.0% in 2010.

In conclusion, more UK institutional investors are committing to stewardship and are increasingly transparent about doing so.

In this context, asset managers are fiduciaries acting on behalf of their clients, they offer their clients a choice and take a range of approaches to managing money. Some believe that actively engaging with investee companies will achieve better returns. Others believe the best way to send a signal to a badly managed company and maximise returns for their clients is to sell their holding. Asset managers have a duty to act in the best interests of their clients at all times. If that interest is better served by decisions to buy and sell shares rather than seeking to persuade companies to change course, then it is not surprising that they should do so. A healthy

⁷⁸ The members of the ISC were: the Association of British Insurers; the Association of Investment Companies; the National Association of Pension Funds; and the Investment Management Association. In 2010 this was reconstituted as the Institutional Investor Committee made up of the Association of British Insurers; the National Association of Pension Funds; and the Investment Management Association

⁷⁹ <http://www.investmentfunds.org.uk/press-centre/2002/20021021/>

⁸⁰ <http://www.investmentfunds.org.uk/press-centre/2009/20090520-01/>

⁸¹ <http://www.investmentfunds.org.uk/research/stewardship-survey>

⁸² <http://www.investmentfunds.org.uk/assets/files/surveys/20120612-stewardshipcode.pdf>

market needs a variety of business models and approaches, and we would not support any prescriptive approach to the matter.

There are also limitations in what such oversight can achieve. Asset managers are restricted in terms of the information that is made available to them. They do not have insider status and are not privy to the same information as the executive or indeed the non-executive directors. It is not unreasonable for fund managers to take in good faith assurances and information from management. UK asset managers also typically have relatively small holdings, particularly in larger companies. However, given the lower propensity for non-UK shareholders to vote at general meetings, a manageable group of UK shareholders could together constitute a significant proportion of those voting on any poll. But, there are concerns that acting collectively with like-minded investors to bring pressure to bear on management could trigger issues of insider trading, changes of control and “the concert party” rules.

In conclusion, there are limitations in what engagement can achieve—asset managers do not run companies; they do not set strategy nor are they insiders, in that they only have access to information that is available to the market as a whole. Managers compensate for such information asymmetries by diversifying their portfolio construction. Nevertheless the main asset managers are committed to good governance and engagement as evidenced by the growing number of signatories to the Code. They recognise that not only does it help ensure that their investee companies are better run but should also help ensure a sustainable and stable financial system.

ANNEX 2

A MECHANISM FOR COLLECTIVE ENGAGEMENT

One of the recommendations in the report was that: “an investors’ forum should be established to facilitate collective engagement by investors in UK companies”. The report states that this is to facilitate supportive and critical action on issues of concern to investors, in general and in relation to particular companies.

The day the Government’s published its response to the Review⁸³ we announced our intention to seek to facilitate the establishment of a mechanism that would respond to the objectives of the Review in this regard.

We are currently engaging with the investment community and completing a series of one-to-one meetings (including overseas, SWF and hedge fund investors) and some group discussions.

At the conclusion of this process, we will seek to determine, with other potential partners, whether it is possible to construct a mechanism that would secure sufficient support to add value to the collective forums that already exist.

ANNEX 3

IMA POSITION PAPER ON FIDUCIARY DUTY

EXECUTIVE SUMMARY

- Discretionary investment management is an agency relationship governed by contract. Fiduciary duties for investment managers arise from their role as agents.
- The contract sets out the detailed rights and responsibilities of the parties. Under the contract, the investment manager owes its client a duty to perform the contract with due care and skill (this is distinct from any fiduciary duty). The contract may modify and circumscribe fiduciary duties which may otherwise apply to the agent/principal relationship.
- UK and EU regulators impose an additional level of protection by substantially codifying many areas that fiduciary duties are intended to address.
- So while contract may modify fiduciary principles, there is a regulatory overlay such that fiduciary standards set in regulation are not capable of being contractually overridden.
- Thus, the principal aspects of fiduciary duties for investment managers are governed by a combination of fiduciary principles at law, contract and regulation.

SCOPE OF PAPER

The paper describes the relationship between a discretionary investment manager and its institutional client, focusing exclusively on segregated mandates. We will be undertaking further work to analyse the position in relation to pooled vehicles.

It describes the agency nature of this relationship from which fiduciary duties arise, the contractual arrangements between the parties and what they are intended to achieve and the regulatory context to which investment managers are subject. The paper explores the relationship and hierarchy between these three aspects: fiduciary principles, contractual obligations and regulation.

A general overview of the asset management business and the various players in the investment chain are set out in the Appendix to this paper.

⁸³ <http://www.bis.gov.uk/assets/biscore/business-law/docs/e/12-1188-equity-markets-support-growth-response-to-kay-review>

The paper sets out the position as a matter of English law and under relevant UK and EU regulation. It does not consider in any detail the legal obligations of an investment manager's direct clients to their own clients, for example where the manager's client is the trustee of a pension scheme.

I. KEY RELATIONSHIPS

Discretionary investment management relationship

A discretionary investment management relationship is a relationship pursuant to which a client engages an investment manager to provide the service of investing that client's assets on its behalf in accordance with certain investment guidelines that have been agreed between the client and the investment manager. Typically, the client gives to the investment manager full discretion to act for and on its behalf to invest a portion of its assets without needing to obtain the client's agreement to any specific transaction.

An example of a discretionary relationship would be Pension Fund X wishing to appoint an investment manager to manage a £100 million of its assets in global equities. As the result of a selection process that we outline in the Appendix, Investment Manager A would be given authority to invest this in line with the agreed terms (the "mandate").

(A discretionary investment management relationship is distinct from an advisory relationship where only advice is provided and the client makes the final investment decision.)

Agency relationship

A discretionary investment management relationship is by its nature an agency relationship with the client as principal and the investment manager as agent having typically been given authority by the client to invest the client's assets.

Contractual relationship

A discretionary investment management relationship is now invariably governed by a contract between the client and the investment manager. Thus the agency relationship between the investment manager and its client arises by express written contractual agreement. This contract is usually known as an "investment management agreement" and it contains, inter alia, an express appointment by the principal and an agreement by the agent to accept the position. As a matter of contract and agency law, the investment manager (as the client's agent) is under a duty to act within the scope of the authority given to it by its client.

Investment management agreements are comprehensive and lengthy documents which, in addition to the agency appointment, cover all matters arising in the relationship from commencement to termination and all matters in between. The investment management agreement will set out the rights, duties and responsibilities of the parties as well as the commercial substance of the contract namely the investment objectives of the mandate, how they will be achieved, any special requirements or restrictions and any appropriate benchmarks and performance standards.

The Investment Management Association has produced a model discretionary investment management agreement which is widely used in the industry. The current model agreement is 45 pages long. It is only a model agreement and is invariably tailored to the specific requirements of the parties. Some investment managers and some clients produce their own version of discretionary investment management agreements. These agreements are usually equally comprehensive and lengthy.

As a general observation, investment management agreements are frequently heavily negotiated between the parties. Clients are often professionally represented in these contract negotiations (whether by their lawyers or, where relevant, by their investment consultant (see Appendix for further details)).

II. THE CONTRACTUAL POSITION

The investment manager has a contractual obligation to provide the services as set out in the investment management agreement. These contractual duties are distinct from fiduciary duties.

The investment manager has a contractual obligation (whether express or implied) to perform its obligations with reasonable care and skill in accordance with the standard of care that could reasonably be expected of a professional discretionary investment manager. The duty of care and skill is distinct from a fiduciary duty.

The duty of care and skill does not exist in a vacuum. It is determined principally by the terms of the service the investment manager has been asked to provide. If a pension scheme client wanted to alter the scope of the mandate it gives to the investment manager, clearly it could do this, but the investment manager's contractual obligation is to follow the mandate given to it by the client. For the investment manager to follow a separate social or other policy that is not in the mandate could be a breach of duty and, if it were a breach, the investment manager would be acting outside the scope of its authority as agent.

If the manager or someone else benefited from such action, conceivably it might also amount to a conflict of interest where the investment manager was favouring someone else's interests at the expense of its client.

It would always be open to Parliament to create new duties by statute, for instance requiring an investment manager when acting for a pension scheme to take account of various matters outside the scope of its contractual mandate. But that would be the creation of a new statutory duty.

Another important aspect of the contractual relationship is that the investment manager has a direct contractual relationship with its client but it does not have a contractual relationship with its client's own underlying clients who are the investors or beneficiaries and may not have any information about them.

So taking the example of a UK trust based pension fund, the investment manager's client is the scheme trustee. The investment manager owes its contractual duties to the trustee and not to the scheme's beneficiaries. The pension scheme trustees have distinct duties and responsibilities towards the scheme beneficiaries.

III. FIDUCIARY PRINCIPLES IN EQUITY

Fiduciary principles were developed in Equity (as opposed to common law) and as a result the evolution of the principles owed much to the situation-specificity and flexibility which are Equity's hallmark. The nature and the scope of fiduciary duties have been developed by the courts over time in cases which examine disparate fiduciary relationships. Further, this is not a static area of law; it will keep evolving. By its very nature and purpose, the concept needs to retain some elasticity.⁸⁴ It is recognised as a complex area of law.

As a matter of English law, certain relationships are considered "fiduciary" relationships giving rise to fiduciary duties. There is no exhaustive list of the categories of fiduciary relationships. The archetypical fiduciary relationship is the trustee-beneficiary relationship but other recognised fiduciary relationships include company directors/companies, solicitor/client and principal/agent. The distinctive feature of agency is that the agent has power acting on behalf of its principal to change its principal's relationship with third parties.

In view of the inherent flexibility of the fiduciary duty doctrine in Equity, there is currently no single all-embracing general definition of what a fiduciary duty involves. Nevertheless, particularly in the context of an agent-based relationship, the nature of the fiduciary obligations are reasonably clear even though they may have been summarised in different ways and have been expressed differently at different times by the courts. For our purposes, in relation to an investment manager, to say that a firm is a fiduciary means that it has a special relationship of trust (though it is not a trustee) and confidence with its client and a corresponding duty of loyalty. The duties ascribed have been variously described as a "duty of loyalty", a "duty to avoid conflicts", a "duty not to make secret profit", a "duty to act in the best interest of the client", a "duty of good faith", a "duty of confidentiality", etc. The Law Commission's approach⁸⁵ in relation to fiduciaries generally (not just agents) was to summarise the fiduciary duty in four basic rules from which the various forms of fiduciary duty could be developed. The four basic rules are:

1. the "no conflict" rule;
2. the "no profit rule";
3. the undivided loyalty rule; and,
4. the duty of confidentiality.

IV. THE ROLE OF CONTRACT AND ITS RELATIONSHIP WITH FIDUCIARY DUTIES

It is crucial to understand that many of the fiduciary principles developed in case law stem from days where there were no detailed contracts. Equity was there to provide certain standards in cases where the contract did not do so or there was no contract. As Equity was effectively stepping in to do something for someone, the standards developed in case law were extremely high and the principles developed were broad brush in nature. Fiduciary duties as set out in the case law are therefore at the strictest end of the scale.

The purpose of a contract between parties is to define the rights and duties arising between them. So for example, in the case of an agency relationship, where this is agreed, the result may be to modify and circumscribe the fiduciary duties which would otherwise apply to a principal/agent relationship.

The scope of fiduciary duties and the impact of express and implied terms on those duties are examined in the leading case in this area *Kelly v Cooper* (1993). This case is of particular importance. It confirmed that where a fiduciary relationship arises out of contract, a clearly worded duty defining or exclusion clause will circumscribe the extent of the fiduciary duties owed to the other party. The Law Commission commented as follows on *Kelly v Cooper*.

"We examined Kelly in detail in paragraphs 3.24–3.36 above, and concluded that it is now clear that the scope of the fiduciary duties owed by an agent to his principal is defined by the express and implied terms of the contract of agency, and that a clear and unambiguous duty defining or exclusion clause will delimit the scope of the fiduciary duties owed to the customer. However, in determining whether a relationship is

⁸⁴ "Equitable principles have above all a distinctive ethical quality. They are of their nature of great width and elasticity ...

[T]he establishment of fiduciary duties ... may arise in any circumstances at all, whether or not similar circumstances have come about previously..." Spry, *Equitable Remedies* (3rd Ed 1984)

⁸⁵ Law Commission of England and Wales *Fiduciary Duties and Regulatory Rules* (no 236 1995 December 1995), paragraph 1.4

*fiduciary, and if so the extent of the fiduciary duties, its description in the contract will not be conclusive if it does not reflect the true substance of the relationship*⁸⁶

If the fiduciary duties were not modified or circumscribed using contractual techniques, the strict principles arising in equity might apply. This may not represent the intention of the parties as to how they wish their relationship to operate and in certain cases a party would not, in practice, be able to comply with the principles which would otherwise apply. It is therefore usual for a contract to define the duty an agent owes to its principal in some detail, with the result that the scope of the fiduciary duties owed are defined by the contract.

V. FIDUCIARY DUTIES AND CONFLICTS OF INTEREST IN THE INVESTMENT MANAGEMENT CONTEXT

In the financial services arena, a firm acting “for and on behalf of its client” is likely to be acting in a fiduciary capacity. Specifically, the agent-based fiduciary is typified by the discretionary investment manager exercising discretion over the client’s assets it manages.

In the context of the relationship between a discretionary investment manager and its client, various potential conflicts of duties and interest may arise. For example, firm/client conflicts may arise in the area of fees and other benefits often involving third parties—covered in regulation by the concept of “inducements” eg a firm pays a commission or fee to a third party which is deducted from the investment the client makes through the firm, or a commission is earned by the firm in connection with its mandate from persons other than the client. Client/client conflicts may, for example, manifest themselves in areas such as aggregation and allocation of a block trade across different client accounts and arranging transactions between clients (agency cross trades).

Investment managers deal with these potential conflicts by setting out the duties and responsibilities of the parties (ie the investment manager’s direct client and the investment manager) in a detailed investment management agreement. The agreement will define the scope of the fiduciary duties owed and what the investment manager can and cannot do. However, the position on conflicts including conflicts management in the financial services area has been substantially codified by regulation. An investment manager, as a regulated investment firm (see Appendix for further details), is required to adhere to that regulation and the contract cannot override any regulatory requirements.

VI. THE FINANCIAL SERVICES REGULATION

Financial services regulation introduces protections in many of the areas that fiduciary duties are intended to address through various conduct of business rules and in particular the conflicts of interest rules. The starting point is the concept of a conflict, not the concept of a fiduciary, although the existence of a conflict presupposes the existence of a fiduciary relationship (in the UK in any event).

The relevant EU legislation for asset managers is the Markets in Financial Instruments Directive (MiFID) and its implementing legislation. MiFID Level 1 Article 19 sets out the general principle for an investment firm to “act honestly, fairly and professionally in accordance with the best interests of its clients...” There are further detailed provisions at Level 2 (Art 26 ff). In the UK, FSA Principle 6 on “Customer’s interests” provides that:

“A firm must pay due regard to the interests of its customers and treat them fairly” and this is also reflected in chapter 2 of the FSA’s Conduct of Business Sourcebook.

The main EU rules on conflicts are contained in MiFID L1: Art 13(3) and 18; Level 2 Art 21–23. In the UK, FSA Principle 8 on “Conflicts of interest” provides that “A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client”. The MiFID conflicts rules are implemented in the UK in SYSC 10 of the FSA Handbook.

The MiFID conflict rules which apply to all discretionary investment managers now require that conflicts are managed as far as practicable and that only those which cannot be managed are then put to the client so that consent to their existence can be sought.

In some cases, regulation deals with certain conflicts by prescribing a particular way of dealing with them. Examples include the best execution rule, rules on aggregation and allocation of trades, rules on inducements and rules on commission sharing.

The regulatory treatment of conflicts is detailed and comprehensive. This section only provides a high level overview.

VII. THE RELATIONSHIP BETWEEN FIDUCIARY PRINCIPLES, CONTRACT AND REGULATION

The contract will define what the rights and obligations are between the parties—and so may affect the fiduciary duties. It would be possible for a fiduciary duty to co-exist with a contract depending on what the contract said. However, if the parties had agreed to something eg how to deal with conflicts, that agreement could change the fiduciary duty that would otherwise apply.

A regulatory requirement takes precedence over a contractual provision in the sense that a regulated person must follow it and can be sanctioned and fined by the FSA if it does not (regardless of what the contract says).

⁸⁶ Law Commission of England and Wales Fiduciary Duties and Regulatory Rule s (no 236 December 1995), paragraph 7.3

Regulatory rules relating to the areas of fiduciary duty may co-exist with fiduciary principles at common law and in equity. The regulators may have refined, restated or modified requirements of a fiduciary duty in a given context in the light of the totality of the safeguards under the regulatory scheme. Regulatory rules may potentially conflict with common law and equitable rules thus giving rise to uncertainty. The Law Commission considered this issue and concluded as follows:

*“We said in the consultation paper that we believed that a court, faced with a mismatch between fiduciary duties and what is required or permitted by regulatory rules, would probably take account of regulatory rules in determining the content of the fiduciary duty. Although there have been no cases since then directly on this point, we believe that the approach of the courts in cases such as Kelly and Target Holdings would tend to support this conclusion. We also accept that contractual techniques can go a long way towards dealing with most problems of mismatch which are likely to occur. We do not consider that, in general, the remaining difficulties and uncertainties are such that we should pursue the provisional recommendation 9 that there should be legislation to the effect that fiduciary duties should take account of regulatory rules in the light of the limited support it received on consultation”.*⁸⁷

We are of the view that while it would be open to the courts to apply a separate common law approach to financial services firms’ conflicts, the regulators’ conflicts rules are likely to be a significant factor in any court decision (provided there was authority to make the rule and subject to a reasonable regulation test). The likelihood is that the two regimes will gradually harmonise with the regulatory regime increasingly being treated as setting the market standard of behaviour and taking the lead in future developments.

VIII. CONCLUSION

The agency model that defines discretionary investment management services gives rise to fiduciary duties for investment managers.

While fiduciary principles at law may not be capable of exact definition and need to retain that inherent quality of flexibility which characterises the law in this area, the principles have been articulated in a reasonably clear manner as regards the principal/agent relationship which is how fiduciary duties arise in a discretionary investment management relationship.

The contract spells out in detail the rights, duties and obligations of the parties. Independently of any fiduciary duties arising, investment managers have a separate and distinct duty of care and skill towards their clients. The contract may modify and circumscribe fiduciary duties which would otherwise apply in the principal/agent relationship. The primacy of contract has been affirmed in a landmark case in this area.

However, in the financial services context, many areas that fiduciary duties are intended to address have been codified in regulation at UK and European level. There is, as a result, a regulatory overlay which contract cannot override.

Therefore, fiduciary duties as they arise in a discretionary investment management relationship are governed by a combination of fiduciary principles at law, contract and regulation.

November 2012

PIRC Analysis of Voting on Director Elections 2009 to 2012

SECTION 1: VOTING TREND ANALYSIS

Table 1

AVERAGE LEVEL OF OPPOSITION BY YEAR FOR ALL RESOLUTIONS

Year	Average Oppose%	Average Oppose & Abstain %	
2009	1.41		1.99
2010	2.00		2.76
2011	1.92		2.80
2012	2.30		3.26

⁸⁷ Law Commission of England and Wales Fiduciary Duties and Regulatory Rules (no 236 December 1995), paragraph 14.20

Table 2

STANDARD DEVIATION OF LEVEL OF OPPOSITION BY YEAR FOR ALL RESOLUTIONS

<i>Year</i>	<i>Average Oppose%</i>	<i>Average Oppose & Abstain %</i>	
2009		4.75	5.82
2010		5.12	6.32
2011		4.49	5.71
2012		5.26	6.92

Table 1 shows that, with the exception of 2011, there has been an increase in the average oppose vote year-on-year. When the definition of shareholder concern is expanded to include abstention there is a year-on-year increase in average shareholder dissatisfaction.

Table 2, shows that over time the standard deviation of opposition and dissatisfaction has increased, indicating more outliers with high levels of opposition. This together with the unconformity of the value year-on-year, indicates that shareholders are not necessarily working together to focus concerns on one particular resolution.

Table 3

FTSE100 DIRECTOR ELECTION ANALYSIS (PROPOSED BY THE COMPANY)

	<i>2009</i>	<i>2010</i>	<i>2011</i>	<i>2012</i>
No. of proposals	491	541	991	1029
No. withdrawn prior to meeting	1	3	5	1
No. put to meeting	490	538	986	1028
No. of directors not elected	0	0	2	0
Average % For	97.73	97.91	97.5	97.4
Average % Oppose	1.57	1.54	1.6	1.5
Average % Abstain	0.66	0.53	0.87	0.60
No. of proposals > 10% Oppose	14	3	17	23

Table 4

FTSE350 DIRECTOR ELECTION ANALYSIS (PROPOSED BY THE COMPANY)

	<i>2009</i>	<i>2010</i>	<i>2011</i>	<i>2012</i>
No. of proposals	1246	1419	2575	2972
No. withdrawn	8	10	10	8
No. put to meeting	1238	1409	2575	2964
No. of directors not elected	0	2	2	0
Average % For	97.15	97.47	97.46	96.48
Average % Oppose	1.81	1.76	1.67	1.88
Average % Abstain	0.86	0.71	0.75	1.02
No. of proposals > 10% Oppose	40	31	56	97

DIRECTORS NOT ELECTED

EURASIAN NATURAL RESOURCES 2011: Sir Richard Sykes and Kenneth Olisa were both voted off the board. The company has a number of significant shareholders who may or may not have voted en-bloc. There are no obvious governance concerns that would lead shareholders to oppose these directors on audit issues. PIRC has contacted the company for further information on this point. To date the company has not responded.

MITCHELLS & BUTLER 2010: 4 directors (Mitchells & Butlers Plc) were to be appointed by shareholders at the 2010 AGM. Piedmont Inc, who is a 22.8% shareholder, put forward these four resolutions. We have concerns over the independence of the nomination process to appoint them, and consider that they might not act in the interests of all shareholders. At the same time two director were not re-appointed.

PROPOSALS WITHDRAWN IN 2012

SVG CAPITAL: Following an immediate press release on 12 March 2012 before the AGM, Denis Raeburn (NED) decided to retire from the board at the forthcoming AGM on 23 March 2012. As a result, Denis Raeburn would not stand for re-election as a director at the AGM.

DECHRA PHARMACEUTICALS PLC: 1 director from Dechra Pharmaceutical Plc withdrew before the AGM. There was no relevance concerning the resolution on the re-election of Simon Evans (Finance Director) since he resigned from the board. The company stated following the acquisitions of other two companies

(Eurovet and Vetxx); it was time to recruit a finance director. There were no other issues in regards to his re-election.

REDROW PLC: 1 director from Redrow Plc withdrew before the meeting. Paul Hampden Smith notified his resignation to the board before the meeting. There were no issues in regards to his re-election. It is worth noting that the executive chairman of the board held around 40% of the company.

AVIVA PLC: 1 director from Aviva Plc withdrew from the AGM. The resolution concerning the re-election of Igal Mayer was no longer relevant as he resigned from the board on 19 April 2012. There were issues about the excessiveness of the company's remuneration structure.

RIT CAPITAL PARTNERS PLC: Three directors from RIT Capital Partners Plc withdrew from the AGM in July 2012. Mr Mikael Breuer-Weil (Executive director) withdrew before the meeting, announcing that he would start his own money management business. Furthermore, as a result of the company's recent strategic investments, Messrs Rick Sopher and Bill Winters withdrew before the meeting and would be joining the board of J Rothschild Capital Management Ltd (JRCM). JRCM is a subsidiary of RIT Capital Partners Plc.

HALFORDS GROUP PLC: One director from Halfords Group Plc withdrew before the AGM in July 2012. Mr David Wild (CEO) left the board as CEO with immediate effect. His sudden resignation came in effect after a profit warning over a consistent period of underperformance.

Information is believed to be correct but cannot be guaranteed. Opinions and recommendations constitute our judgement as of this date and are subject to change without notice. The document is not intended as an offer, solicitation or advice to buy or sell securities. Clients of Pensions & Investment Research Consultants Ltd may have a position or engage in transaction in any of the Securities mentioned.

**Short statement provided (in personal capacity) by Harlan Zimmerman of Cevian Capital
(Providing oral evidence 26 February, 2013)**

NON-EXECUTIVE DIRECTORS AND FAILURES IN THE PRINCIPAL-AGENT RELATIONSHIP⁸⁸

Over the last years equity markets have done a poor job of providing capital for British business. They have also done a poor job of acting as a control mechanism to steer British listed companies towards the sort of behaviour that society requires and, increasingly, demands.

The Kay Review comprehensively discusses the problems associated with principal-agent relationships throughout the investment chain, but has virtually ignored the all-important relationship between the shareholders (the principals) and non-executive directors (or NEDs, who are agents). While NEDs have obligations to their companies as a whole, shareholders alone vote on NED appointments so that they may select NEDs who they can entrust with the stewardship of the companies that they own.

However, this is not how things have been working in practice, and this is the root of many problems.

Shareholders have largely abdicated their right to appoint NEDs, as voting for NEDs has become a largely farcical rubber-stamping exercise that (to borrow from Lord Myners) would embarrass even the North Koreans. As evidence, note data from PIRC on FTSE 100 director elections for 2009–2012: There were 3,042 votes on director nominees during this period. In 3,040 cases (99.34%), the nominees were voted onto the board. (two nominees were voted down by controlling Kazakh owners). Average “yes” votes were c. 97.5%. Even in 2012 (the so-called “shareholder spring”), 100% of FTSE 100 nominees were voted through, with an average “yes” vote of 97.4%.⁸⁹

(This behavior is especially disappointing as appointing directors is the shareholders' single most powerful tool of ownership, and by failing to exercise it, they are failing to fulfill their “*primary role in promoting the accountability of management and boards for the performance of their businesses.*”⁹⁰)

It is the boards themselves (normally really the chairmen) that control the NED nomination process. Thus, with 99.34% success rates, the boards (chairmen) effectively control the entire appointment process. In other words, the chairmen are selecting their own board members. This is a very bad outcome that is the root cause of much sub-optimal behaviour.

Human nature means most chairmen will avoid selecting “natural challengers,” and most NEDs—having been given their job by the chairmen—will not be comfortable rocking the boat. (They also understand that appointments to other boards will be difficult without a good reference from their chairman).

When chairmen select NEDs who are not natural challengers, and when NEDs are uncomfortable rocking the boat, the result is a lack of challenge in the boardroom. This leads to poor decision-making, limited accountability and improper alignment of interests. (The Walker Review of BOFIs pointed to lack of boardroom challenge as a major cause of the sort of behaviour that led to the financial crisis).

⁸⁸ Many of the points in this document are discussed in greater detail in Cevian's submission to the Kay Review.

⁸⁹ During these four years there were also a total of 10 director proposals that were withdrawn prior to the vote. Comparable figures for FTSE 250 companies were 5,134 director votes, all but two were appointed. 26 withdrawn.

⁹⁰ Text in italics taken from the background information and call for evidence of the Kay Review.

Furthermore, NEDs virtually never even meet shareholders (other than the chairmen and occasionally senior independent directors). They rely on CEOs and CFOs (who do meet shareholders) and corporate banking advisors to inform the board about shareholder views. As the interests of management and bankers often diverge from the interests of shareholders and society at large, this is clearly sub-optimal.

Lastly, in an election system with candidates chosen by a single party and 99.34% of candidates winning their races, it is doubtful that the winners would feel empowered by a true mandate from the voters. It is likewise difficult to believe that NEDs feel any sort of true mandate or backing from shareholders.

CONSEQUENCES OF POOR BOARD BEHAVIOUR

Poorly functioning, out-of-touch, non-accountable boards display many symptoms that are damaging for stakeholders and society. These include:

- Inappropriate risk-taking, strategic errors, poor acquisitions and capital management—arising from insufficient control over ambitious management teams, who often have asymmetric incentives and a desire to expand their domains.
- Weak governance—chairmen, NEDs and executives who perform “well enough” to keep their seats, but are not compelled to drive a company to its potential; poorly managed succession processes.
- Executive remuneration—Plans with targets that are too low, purely financial, and poorly aligned with the interests of shareholders and wider stakeholders; inappropriate benchmarks and structures; and unreasonably high levels of compensation.
- Corporate underperformance—arising from un-ambitious, unchallenging and inappropriate target setting.
- Short-term focused decision making—resulting from a lack of a mandate from shareholders, and thus a constant fear of missing quarterly estimates and disappointing “the market.”
- Lack of diversity—A lack of diversity within the board, resulting from managed nomination processes that lack transparency and objectivity, and that favour the “old boys’ network.”

Shareholders, other stakeholders and policy makers have limited time and resources. Much effort is expended on trying to address individual issues such as the ones listed above. However, it would be more efficient, and more effective, if attention were focused primarily on comprehensively improving board behavior, which would address many symptoms at one time.

SHAREHOLDER INVOLVEMENT IN BOARD NOMINATIONS

We believe that the most tangible and realistic way to comprehensively address poor board performance is to directly involve shareholders in the company’s NED nomination process.

This system operates well in Sweden (as well as in Norway and at most large companies in Finland) and benefits all—shareholders, companies, directors and society at large. While it would be inappropriate to simply take the Swedish system and apply it to the UK, there are important lessons that can be drawn from the Swedish experience. (An idea would be to involve shareholders in nominating only chairmen).

Like there was initially in Sweden, there is much resistance to this approach in the UK. The status quo suits current chairmen and NEDs, who can say they are in fact very responsive to non-public dialogue with shareholders (while keeping their ability to self-determine and perpetuate). Most institutional asset managers, meanwhile, will say they are very active behind the scenes (when this is true in very limited cases), and thus the current (low-cost, low responsibility) works reasonably well.

The Kay Review briefly mentions, but does not consider seriously, the possibility of involving shareholders in NED nominations (and the issues it would address). This is a missed opportunity. It is possible that Professor Kay felt, as with some other ideas paid scant attention (eg differential voting and dividends), that resistance would be so great, there would be little point in advancing such approaches. That would be a disappointing stance from such a respected thinker, chosen from out of the box, presumably to suggest some out-of-the-box solutions to the difficult problems we face.

Harlan Zimmerman
 Senior Partner
 Cevian Capital (UK) LLP
 22 February 2013

**Written evidence submitted by Fidelity Worldwide
(Providing oral evidence 26 February, 2013)**

I would like to thank you for your invitation to appear before the BIS Committee as it considers the Kay Report. Professor Kay has written one of the most authoritative reports on asset management that I have read in over 25 years in the industry. It is thought provoking, and I believe can help the industry define its purpose and future role.

While the report raises numerous serious issues that will require thorough discussion, there are three topics I would like to highlight before the panel hearing which may help the Committee's deliberations.

Firstly the report proposes that remuneration within asset management should be based on long-term, equity ownership. Fidelity endorses this proposal and believes that there is a strong case for reform. Long-term incentive plans are seldom longer than three years, which we consider too short. We feel that equity should be held for a minimum of five years, or, as in our case, until the individual leaves or retires. Once asset management remuneration has been reformed, the industry will be better placed to encourage boards in other industries to adopt longer term remuneration schemes.

Secondly, the report highlights the stewardship responsibility of asset management, and the broad benefits that yield from boards answering to an engaged shareholder basis. We would agree with this conclusion and have a very active corporate governance team engaging with UK companies on a daily basis. However, we find that many in our industry still 'vote with their feet', selling shares they deem unattractive rather than seeking to improve corporate performance. This is the 'free rider' problem. We would also add that the regulatory framework does not naturally assist a close working relationship between board and shareholder in the public market.

The market abuse regime, with good reason, restricts the information asset managers can receive, limiting the influence shareholders can bring to bear on directors. Somehow we need to resolve the twin goals of engagement with uniform information.

Finally, Kay argues that the industry has become too short-term. This manifests itself in a culture of quarterly performance reviews, high asset turnover, falling levels of client retention, and a plethora of new products such as hedge funds which cater to these trends. We agree that the industry has become too short-term in its thinking, and the persistency of client assets is an industry-wide problem. Our experience is that client persistency is weakest through bank distribution channels, and highest when we have a direct relationship with the client. There is certainly a need to simplify the layers of intermediation in the industry, while retaining the benefits that open architecture offers clients in terms of choice, transparency and cost.

There is so much in the Kay Report that warrants discussion. I am sure that I will be unable to do it justice, either now or during the panel session. However, I hope this letter will help your Committee extract as much from the panel session as it can.

Dominic Rossi
Global Chief Investment Officer
22 February 2013

Supplementary evidence submitted by Fidelity Worldwide

I greatly appreciated the opportunity to submit evidence to the Business, Innovation and Skills Committee last week as part of your deliberations on the Kay Review of UK Equity Markets and Long-Term Decision Making. There were two points on which I wanted to come back and expand on.

The first relates to question 150 and whether the shares managed by Fidelity International are classified as UK-owned or foreign-owned. I feel that I should elaborate my response, as the problem is that there are a number of answers. The official ownership is usually decided either by where the assets are managed or by the underlying beneficial ownership; but our attitude to our responsibilities is the same regardless of the beneficial ownership.

In London we manage £61 billion, £39 billion of which is managed for foreign clients and £22 billion for UK clients. The assets we manage for foreign clients would be classified as foreign-owned. Looked at another way, in terms of our investment for clients in UK equities, which would be the pivot for our stewardship role in the UK market, as of 31 January 2013 we managed £8.5 billion in UK equities for UK retail and institutional investors. We also invest approximately a further £4 billion in UK equities through other vehicles such as Pan-European and Global funds. These investors are likely to be from around the world. Our responsibility towards our investments in UK assets and the UK economy is the same regardless of ownership.

The second point relates to question 174 and Fidelity International's voting record. I indicated to the Committee that we had voted against management at 20% of the General Meetings in 2012.

Having revisited the specific figures, I can inform you that globally we voted against management on at least one resolution at 18% of the meetings at which we voted and that 33% of these votes related to Board

appointments, 31% to remuneration, 14% were in respect of shareholder proposals, 13% related to capital structure and 9% other.

I hope this is helpful but please feel free to contact me if you have any further questions.

*Dominic Rossi
Global CIO, Equities
5 March 2013*

**Written evidence submitted by Dr Paul Woolley
(Providing oral evidence 26 February 2013)**

In his introduction to the Government's response to the Kay review, Dr Vince Cable talks of "the prevalence of incentives to focus on short-term market movements rather than long-term value creation as the basis for investment decisions". The standard theory of finance cannot explain mispricing, short-termism and other market failures. That is why solutions have been elusive. My team has been developing a framework that addresses these issues and offers an agenda for reform of investment practice.

INVESTMENT VERSUS TRADING

There are basically only two investment strategies: investing based on fundamental value and momentum trading, or trend following. Everything investors do is a variant of one or other strategy, or some combination of the two.

Fundamental investing requires investors to estimate the future cash flows from securities and asset classes. This calls for skill and patience: skill in making the estimates and judging the risks, and patience while waiting for these judgments to be vindicated.

Momentum trading involves investors buying and selling assets simply in accordance with the prevailing trend in prices. It involves a succession of independent bets on the direction of those prices. The investor makes no judgment about the fundamental value of the security.

Investors use momentum either to try to make a quick turn, or to reduce the risk of underperformance in the short run. The distinction between the two strategies lies at the heart of the problem of short-termism and it goes beyond the debate about length of holding period.

Our analysis shows that while momentum traders may gain in the short-term, they lose out to fundamental investors in the medium and long-term. The reasons for this include that they are inevitably late to the party—buying after prices have started to rise and selling after they have begun falling. Momentum locks in losses, whereas the longer-term investor rides the troughs and enjoys the recovery when prices revert to the mean. The trading costs involved in "churning" the portfolios also detract from returns due to the ultimate asset owner.

"Momentum" is not just counter-productive for the medium to long-term investor. It is also a key component of the herd behaviour that leads prices to over- and under-shoot the fundamental value of the underlying assets. This damages market efficiency, making prices prone to excessive volatility, bubbles and crashes.

Given these clear drawbacks, why are pension funds and other long-term investors nevertheless drawn into the momentum game, either explicitly by pursuing short-term performance, or unwittingly via benchmarks and risk measures calculated using market prices? The reasons include:

1. Benchmarking to market-value-based indices. This effectively means buying high and selling low, and accepting prices that are distorted by momentum surges. Index-tracking is thought of as a cheap option, but it ties the investor to benchmarks mispriced by momentum trading.
2. Imposing limits on the divergence of fund returns from the benchmark's returns (to limit "tracking error"). This requires the fund manager to use momentum to hug the benchmark index to reduce the commercial and professional risks of underperformance.
3. Hiring "quant" managers guarantees that momentum will be part of the package. Similarly, most hedge funds use momentum as a core strategy overtly or covertly. Their high fees make the client impatient for quick results.
4. Paying performance fees based on annual returns encourages a short horizon and, therefore, momentum investing.
5. Focusing on mark-to-market valuations, compounded by regulatory requirements, leads to unnecessary—and often self-defeating—efforts to minimise short-term losses and volatility.
6. Bowing to pressure to measure performance against existing comparator universes can encourage herding in asset classes, pushing funds into the latest fashion (commodities, hedge funds, gilts) often with pleasing short-term results but disastrous longer-term outcomes. So careful choice is needed to ensure the comparators are relevant to the asset owners' needs.
7. Over-using derivatives (futures, options, structured finance), which are by definition short-term because most instruments expire in less than 12 months. Any fund manager using derivative strategies will be

focusing on either short-term gains or short-term risk reduction. The Kay Review failed to refer to the derivatives markets, which have now grown to be many multiples larger than the market in the underlying instruments.

What can be done about it?

We have written a Manifesto (see *The Future of Finance*, LSE Report 2010) for giant funds, such as pension funds and sovereign wealth funds. The Manifesto is our version of a code of best practice for long-term investors. It goes further than Kay's proposed statements of best practice for asset managers and asset holders. As is made clear in the G30's recent publication, "Long-Term Finance and Economic Growth", this is an international issue. Its number one proposal is that regulators at all levels should "promote long-term horizons in the governance and portfolio management of public pension funds and sovereign wealth funds".

The main aim of the Manifesto is to show funds how to reduce momentum trading and increase the focus on fundamental investing. If implemented, this would raise the medium- and long-run returns of individual funds irrespective of what other funds do. If large numbers of funds followed suit, markets would become more efficient and less exploitative. The key points of the Manifesto are:

1. Concentrate on investing based on the future cash flows of the assets and their ability to meet the cash obligations dictated by the liabilities.
2. Base all risk metrics for the assets on underlying cash flows, not current market prices.
3. Choose a cash flow-based benchmark tailored to the currency base of the investor, such as real global GDP growth plus local inflation.
4. Avoid investment strategies based implicitly or explicitly on momentum ie bets on price trends, or where buying/selling is prompted by automatic reactions to price movements.
5. Cap annual turnover of the portfolio at an indicative 30%. Managers would have to explain and justify excess turnover and the capping would force managers to focus on long-run value.
6. Design contracts with agents to minimise moral hazard, eg avoiding performance fees other than over the long-term.

We strongly advocate establishing a code of best practice for long-term investors along these lines. This could be backed up with the withdrawal of existing tax concessions for institutions that breach key provisions, such as the 30% limit on portfolio turnover. The authority to withdraw tax exemption if funds are deemed to be trading rather than investing has lain dormant and little used in the UK tax statutes for the past 30 years.

Because of their pro-cyclicality we also discourage the imposition of annual snapshot mark-to-market valuations for long-term funds. The regulation of both pension funds and insurers has moved in the direction of extending the requirement for, and frequency of, mark-to-market valuations. This is a retrograde step that trumps attempts by funds to adopt a long-term strategy. This legislation comes in response to volatile and treacherous markets yet will have the effect of making matters worse, not better.

As funds begin to adopt the new practices, a new comparator universe of long-termist funds would be created. This would ease the concerns of those who fear short-term underperformance in the event of a new momentum-fuelled bubble. The other side of the coin is that members of pension schemes would be able to challenge trustees who fail to comply with the new code and suffer underperformance as a result.

Curbing short-termism would also be a big help in shrinking agency costs. Short-termism and volatility have contributed greatly to agents' ability to capture rents through moral hazard (heads the agents wins his fees, tails the client loses). More stable markets would make the finance sector less bloated and prone to crisis.

Action along the lines set out above would address several of the problems diagnosed by Kay for the asset owners' end of the chain. International opinion is also moving in this direction—see the G30 report published this month (as mentioned above).

In the UK, it is clear from the Government's response to Kay that it not only shares his diagnosis but is keen to see a fundamental change in investment practice. This includes essential regulatory reforms to favour investing over trading. The response also rightly indicates that a new financial framework is needed, since it can no longer be assumed that markets will achieve efficient outcomes. Hence the call for reviews of both metrics and risk management models.

We also welcome the Government's defence of the role of equity markets, in paragraphs 2.24 and 2.15 of its response to the Kay Review. Kay's dismissal of the value of equity markets as a source of funding may be a correct observation of the current facts, but equity markets are and should be the lifeblood of capitalism. They are failing because of the short-termism of all the players in the market, including corporations, and the rent capture by agents. The current policies of regulators are exacerbating the problem because, like the rest of us, they remain in thrall to the defunct theory of efficient markets, which assumes that market prices represent "fair value" in the sense of rational expectations of future cash flows.

POTENTIAL CONTRIBUTION TO FINDING SOLUTIONS

My colleagues and I have been planning for some time to establish a research forum to work with selected policy-makers, sovereign wealth funds, pension and charitable funds globally (similar to that suggested in Kay). The forum would help policy-makers draft the code of best practice for long-term investors and assist funds in implementing the code. It would also provide the new metrics for setting benchmarks and analysing risks. In addition, it proposes a code that would help companies to invest for the long term, in the context of reforms to the approach of investors.

The issue is a global one and we are addressing things at that level. Our approach is founded on the new framework we are developing for understanding finance (see attached article, “Capital market theory after the efficient market hypothesis”). The principal departure from the prevailing theory of efficient markets is to introduce the real-world feature that asset owners delegate management of their funds to agents such as asset managers, investment banks and brokers. Because the prevailing theory of finance is based on the efficiency of prices, it will never successfully explain price distortions, short-termism or other market failures. It certainly will not provide solutions. In contrast, our framework suggests the causes, consequences and remedies for market failure.

Since the Centre started at the LSE in 2007—before the financial crisis struck—our work has attracted widespread interest from academics, some policymakers and international agencies, journalists around the world and a select few practitioners. Most encouraging has been the reaction of sovereign wealth funds and large funds overseas, notably the Australian pension fund community. In the UK, while a change in approach would clearly be in the interest of pension scheme members, it is early days in the reform process. The outcome of these parliamentary hearings should provide impetus to that.

To get UK pension funds to show interest and even consider action will need a significant catalyst. It will take more than setting up a forum. The development and promulgation of a code of best practice would be a start, whether this comes from the IMF, Financial Stability Forum or some other national or supra-national body. The new code would act as a carrot to action, but it will also need a stick in the form of legislative back-up or the trustees’ fear of challenge by their members.

OTHER ISSUES

Company stewardship and engagement with management

We have focused on the asset owners’ end of the chain rather than on the investee listed companies. This is partly because our Manifesto is aimed at funds that will invest in a broad range of asset classes, not just domestic equities. We also believe that if the owners of the assets were focused on the cash flows from them, much of the responsible ownership behavior that Kay calls for would inevitably follow. Where engagement with the management would improve long-term performance, it would make sense to do it.

This would encourage managements to focus on long-term value creation. It would also discourage financial engineering and ill-thought-out takeovers—actions that might enhance short-term earnings but could be counter-productive longer term. It should also encourage management to be more relaxed about cyclical profit volatility or temporary suppression of earnings for investment purposes. This, in turn, might lead to less trading activity by company treasuries in the name of risk management, including in the derivatives markets.

INVESTMENT CHAIN AND COSTS

Three other elements of the Manifesto (see below) tackle the issue of too many intermediaries between savers and the assets they own, and the cost of those layers. They chime with other calls to make costs transparent and to hold intermediaries more closely to account. Combined with the discouragement of momentum trading, a welcome side effect would be to reduce the number of links in the investment chain.

1. Insist on total transparency by managers with respect to their strategies, costs, leverage and trading.
2. Work with other shareholders and policymakers to secure full transparency of banking and financial service costs borne by companies in which the large funds invest.
3. Provide full disclosure to all stakeholders and allow public scrutiny of each fund’s compliance with these policies.

I hope that this submission, coupled with evidence given on February 26, will help the committee to achieve Dr Cable’s goal of installing “long-term value creation as the basis for investment decisions”.

*Dr Paul Woolley, senior fellow, London School of Economics
The Paul Woolley Centre for the Study of Capital Market Dysfunctionality
25 February 2013*

Written evidence submitted by USS Investment Management Limited

Please find additional information following my recent appearance at the BIS Select Committee inquiry into the Kay Review of UK Equity Markets and Long Term Decision Making on 26 February 2013.

We provide below additional information in response to two questions posed by the Committee Chairman. We also highlight some key points that the Select Committee should consider in its deliberations. Finally, we provide information requested on USS's voting statistics requested during the discussions.

Q135/Q136 Chair: *Do you feel that organisations were sufficiently consulted by Professor Kay?*

We feel that the voice of pension funds—the asset holders for many of the assets in the UK—could have been better heard. Unfortunately, most pension funds lack the resources to contribute fully to such consultations and will almost invariably have their voices drowned out by better resourced intermediaries who may have a vested interest in the status quo. Those pension funds that are heard are usually the large ones including USS, BTPS, and RailPen, the funds that tend to be most actively involved in debates around long term investment and have the internal resource to do so.

We would also note that in our view, the brief given to Professor Kay was too focussed on one aspect of the investment universe—namely UK equities. Pension funds have a broader asset allocation, and in most cases the allocation to UK equities is decreasing. The inability to look beyond listed UK equities (eg to private equity, infrastructure and property for which stewardship and long-termism are also vital) has minimised the possible effectiveness of the review in terms of its benefits for UK investors and society.

Q138 Chair: *You also said to Professor Kay that “there are likely to be different solutions to the agreed problems.” Now, given the fact that we are trying to hold an inquiry to come to an agreed solution to agreed problems, what exactly did you mean by that? In effect, what would your solution be to what I think are generally agreed as the problems?*

It would not be sensible for government to try to dictate *one* approach or “silver bullet” to address the current problems with long term ownership/stewardship, and different funds will find their own way of achieving this. We highlighted in our joint submission with two of the other large UK pension funds (BTPS and RPMI), that we have each adopted different models, none of which involves outsourcing stewardship functions to external investment managers.

- USS has adopted a largely in-house investment management and stewardship function.
- Railpen's investment management function is entirely outsourced with stewardship led internally with a partial outsourcing to a specialist provider.
- BTPS' stewardship is undertaken by Hermes Equity Ownership Services (EOS) which sits within the asset manager BTPS owns and which otherwise manages only a portion of BTPS' assets.

For the smaller UK pension schemes who decide to delegate their responsibility for stewardship, we recommended efforts should be made to form collaborations between asset owners as this provides a mechanism to both reduce costs and increase the impact of such activities. USS, though itself a relatively large scheme, has benefitted by establishing a voting and engagement alliance with RPMI Railpen.

We also recognise there may be other solutions, and we would welcome our peers working to develop these. In addition, there are a number of formal collaborations where pension funds and asset managers work together on stewardship and other issues.

- The International Corporate Governance Network⁹¹ is collaboration between investors mainly focussing on improving global standards in corporate governance.
- The UN backed Principles for Responsible Investment⁹² operates an Engagement Clearing House, where signatories can get join together to engage with companies on specific issues—this is a kind of ‘a la carte’ investor panel.
- Eumedion⁹³ is a collaboration between Dutch investors which focuses on improving standards in companies in that market.
- The Australian Council of Superannuation Investors⁹⁴, is an exclusively pension fund group which engages on behalf of its pension fund members to improve governance and other long term issues.
- The Institutional Investors Group on Climate Change (IIGCC)⁹⁵ is a pan European collaboration focussing specifically on how the long term issue of climate change, and shorter terms policies to address it, could impact pension funds and other investors.

These are just some examples of where pension funds have come together to find solutions to specific issues related to their investments.

⁹¹ <https://www.icgn.org/>

⁹² <http://www.unpri.org/>

⁹³ <http://www.eumedion.nl/en>

⁹⁴ <http://www.acsi.org.au/>

⁹⁵ <http://www.iigcc.org/>

 KEY CONSIDERATIONS FOR ENCOURAGING LONGER TERM INVESTMENT

The following are a number of key points we believe the Select Committee should consider in its response to the Kay Review.

- *Leadership from the top:* we need to see board members taking the lead in terms of a long term focus at corporations, and trustees taking a lead at pension funds. This means the directors/trustees have to have the requisite skills to challenge management and the financial services chain.
- *IFRS and pension regulation:* The introduction of IFRS/mark to market accounting for pension funds has exposed funds to increased volatility and some difficulty in incorporating assessments that markets have overshot (in either direction) or that future income streams are not impaired to the implied degree. Such volatility and the potential introduction of Solvency II will be detrimental to investment in risk seeking assets such as public equities and other “risky” assets, including infrastructure—with adverse consequences for growth and for the affordability of adequate pension provision.
- *Investor Forum:* Pension funds and other asset holders are less likely to be conflicted, therefore should take a central role in any investor forum or vehicle established for collaborative engagements. The forum should also be adequately resourced, and needs to be free from the potential conflicts of interest which may exist within representative bodies for the wider industry.
- *Remuneration:* should be appropriately structured to encourage executives to manage business for the long term rather than for quarterly targets, and for investment managers to invest for the long term.
- *Pension fund scale:* UK pension funds are in general too small to adequately resource their stewardship operations. There is therefore too much reliance on intermediaries, which increases cost and thus decreases the return to pension members. Consolidation in the pension sector would increase professionalism and capacity to engage more fully in stewardship, as well as benefitting members (and taxpayers for public schemes).
- *Infrastructure:* The UK government and pension funds both wish to engage in other forms of long-term investment, including ‘illiquid’ investments such as infrastructure. USS is looking to invest increasingly in long-dated, inflation-linked income streams, in areas such as infrastructure, but there are some impediments to fulfilling this objective.

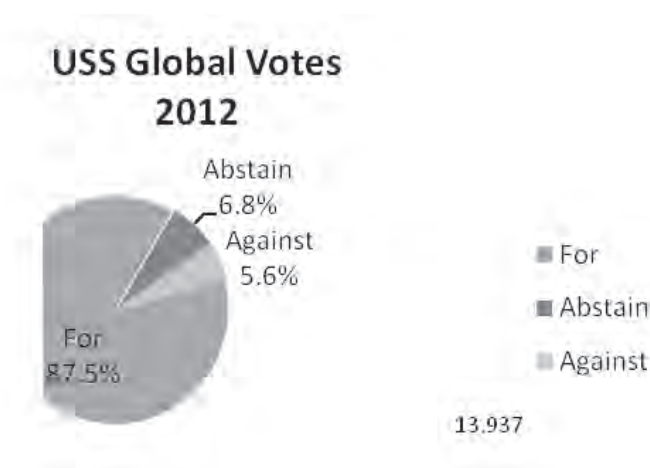
USS VOTING STATISTICS 2012

GLOBAL VOTING 2012

- The fund regularly votes >92% of its equities under management in the following markets: UK, USA, Japan, Australia, France, Netherlands, Germany, Switzerland, Spain, Belgium, Luxembourg, Brazil, Taiwan, Korea, and Russia. The fund may vote in other markets eg where we have a large holding, there is a material vote, or at the request from the portfolio manager.
- The fund has processes in place to recall shares from lending ahead of important voting events, and/or where we are a significant shareholder.
- All votes are reviewed and analysed by the in-house RI team.
- The fund usually writes to companies to explain the rationale behind votes against management, ahead of the meeting, where possible. The main issues highlighted include independent representation on the Board and its committees, auditor independence, misalignment of pay with performance, minority shareholder rights, dilution concerns, lack of transparency and disclosure.

2012 GLOBAL VOTING STATISTICS

13,937 resolutions voted	(2011:14,329;	2010: 12,153)
1,128 events	(2011: 1,170;	2010: 1,118)
934 companies	(2011: 961;	2010: 892)



Breakdown of how we voted on 13,937 global resolutions:

For	87.5%	12,199 res	(2011: 88%;	2010: 89%)
Against	5.6%	787 res	(2011:6%	2010: 4%)
Abstain	6.8%	951 res	(2011: 6%;	2010: 7%)

This represents “voting against management”⁹⁶ at least once at 54.9% (513/934) of companies during the year.

UK ONLY STATISTICS

USS voted 10,113 resolutions at 823 events at 654 UK companies in 2012 (including FTSE All Share, AIM, Fledgling and Plus market companies)

Breakdown of how we voted on 10,113 UK resolutions

For	93.0%	9,410 res	(2011:92.5%)
Against	2.8%	284 res	(2011:2.5%)
Abstain	4.1%	419 res	(2011:5%)

This represents “voting against management”⁹⁷ at least once at 341/823 UK events, and at 49.1% of companies (321/654) companies during the year.

15 March 2013

Supplementary written evidence submitted by Aberdeen Asset Management plc

INQUIRY ON THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING

You were kind enough to invite me to give evidence on 26 February at which time I undertook to follow up on a number of points raised during the session, including Aberdeen’s corporate governance process, company visits we undertake and the number of investment professionals in our UK/European equity team.

CORPORATE GOVERNANCE

Corporate governance and engagement are key components of our investment process in our active equity business. A review of the corporate governance practices of a potential investee company is part of our initial screening process and we only make an investment after we have conducted meetings with the management team. Once we have invested in a company, we hold regular meetings with management and board members to discuss strategic, operational, risk and governance matters and aim to visit companies in our core portfolios at least once a year but, in practice, it is often at least twice annually. Engagement is therefore embedded in our investment process which is reinforced with all voting decisions being taken by our investment managers.

⁹⁶ Includes against, abstain and withhold

⁹⁷ Includes against, abstain and withhold

By considering corporate governance as a key element of broader investment analysis, we avoid the box-ticking approach that ignores the particular circumstances of each company and prevailing market practice. With an equity investment process that emphasises investing for the long term, we feel that Aberdeen's funds will benefit from the gradual value creation that will result from a company's governance reforms over time.

One of the purposes of engagement is to encourage companies in which Aberdeen is an investor to strengthen their governance practices. Engagement with a company is most effective where it is built upon a long term relationship with the board and senior management, who are more likely to see Aberdeen as a credible and committed owner. Engagement is undertaken through a variety of formal and informal channels, ranging from participation in Annual General Meetings to private company meetings and formal correspondence. Engagement is complementary to both investment analysis and proxy voting because it allows Aberdeen to address specific governance concerns rather than simply divesting or voting against management without explanation. Where contentious issues arise in relation to motions put before a shareholders' meeting, Aberdeen will usually contact the management of the company to exchange views and give management the opportunity to articulate its position. If this approach proves unsatisfactory we may express our concerns through the company's advisers, discuss the issue with other shareholders or attend and speak at General Meetings.

COMPANY VISITS—NUMBER HELD

<i>Analysis of company meetings</i>		<i>12 months to 30 Sept 2012</i>	<i>12 months to 30 Sept 2011</i>
Regular company meetings lie at the core of our investment process and discussions may be wide ranging and cover strategic, operational and governance issues. Many of the meetings outlined in our Equity Engagement and Voting Report will have been initiated by Aberdeen but we welcome the increasing trend of chairmen, independent directors and chairmen of remuneration committees contacting us to discuss topical issues.	Asia ex-Japan	1,760	1,659
	Japan	248	229
	Emerging Markets	714	749
	North America	710	592
	UK	369	413
	Europe	315	176
	Total	4,116	3,818

ACTIVE EQUITY INVESTMENT

At the end of December 2012, we had over 95 active equity investment professionals, with 16 in the UK/European equity team. Globally, we have 2,045 employees, including over 500 investment professionals in total.

By way of background, I have also included copies of three documents we publish—the UK Stewardship Code, our Equity Engagement and Voting Report and Aberdeen's Corporate Governance Principles together with an analysis of proxy votes for UK companies (in the 12 months to 30 September 2012, Aberdeen voted over 9,000 resolutions at more than 700 shareholder meetings).

*Anne Richards
Chief Investment Officer
22 March 2013*

Supplementary written evidence from Government

Further to our recent telephone discussion noting the Committee's interest in the funding arrangements for the Law Commission's review of fiduciary duties, I am pleased to outline these in writing.

The project is additional to the agreed Law Commission work programme. BIS and the Department for Work and Pensions will therefore jointly provide to the Law Commission funds sufficient to meet the costs associated with the project, up to but not exceeding £90,000 for the financial year 2013–14, and £50,000 for the financial year 2014–15. The contribution will be divided equally between BIS and DWP, and will be payable quarterly in arrears on the Law Commission's invoice. Our expectation is that the total costs for the current financial year will be in the region of £75,000.

Alastair Cowie
Assistant Director, Corporate Governance
Department for Business Innovation and Skills

25 June 2013

Written evidence from the Financial Reporting Council

You asked how best to calculate the proportion of the UK market managed by signatories to the UK Stewardship Code.

The most recent data we have on this is from the IMA Stewardship Survey, which was published last month at <http://www.investmentuk.org/research/stewardship-survey/>

The IMA reported that the 103 respondents to this year's survey included 73 managers who are responsible for £702 Billion of UK equities representing 36% of the UK market.

As we discussed, the Code currently has 283 signatories, which comprises 203 Asset Managers, 67 Asset Owners and 14 Service Providers (1 organisation is listed as both an asset manager and a service provider). Given not all signatories responded to the IMA survey, although most of the largest managers did respond, it would therefore be reasonable to say the overall total is slightly higher than the IMA's figure.

Jocelyn Brown
Corporate Governance Adviser
Codes & Standards Division

11 July 2013

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