Department
for Business
Innovation & Skills

ENSURING EQUITY MARKETS SUPPORT LONG-TERM GROWTH

The Government Response to the Kay Review

NOVEMBER 2012

Foreword

Professor John Kay has produced a detailed and insightful analysis of investment in UK public companies, and a series of thought provoking recommendations. His report presents a clear challenge, calling for a shift in the culture of investment in the UK to address misaligned incentives, restore trust and confidence in the investment chain, and tackle the short-termism which too often impedes the creation of sustainable value by British companies.

Professor Kay rightly acknowledges that the UK has led the world in the development of an effective, flexible framework for corporate governance and investor stewardship, and that many companies, asset managers and asset holders already take a long-term approach to investment.

However, he also highlights the prevalence of incentives to focus on short-term market movements rather than long-term value creation as the basis for investment decisions. He argues that this has been driven by 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. Not only are trust and confidence vital to ensuring that the UK financial services industry continues to lead the world and play its part in our future prosperity, but also that it serves the needs of the wider economy.

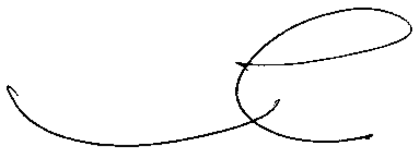
Professor Kay reminds us that markets are for customers, and that we should measure their success not just in terms of economic efficiency – important though this may be – but in terms of their ultimate effectiveness in supporting companies to succeed: to grow, to generate financial returns for savers, and to create jobs. It is this which fosters the creative talents of the British people, facilitates investment in innovation and skills, and underpins the global competitiveness and growth of the UK economy.

The Kay Report has already generated a great deal of debate about the need for a change in the culture of investment. We have seen a broad acceptance of Professor Kay's analysis, but some scepticism about whether change is achievable, and whether the Government, UK companies and the investment industry can bring it about. Today we set out a detailed response to the report's specific recommendations, highlighting the steps government is taking and areas where we are already seeing encouraging progress.

Many of Professor Kay's recommendations, principles and directions are not for government but for market participants. It is central to his vision that the necessary changes in culture cannot simply be achieved through regulation, but rather through the development of good practice in the investment chain. It is therefore not just for government to respond to the challenges which emerge from this report, but also for companies and institutional investors. To that end we are challenging leading representative bodies in particular to review the report's Good Practice Statements, signal to what extent they can endorse them to their members, and suggest how good practice standards might be further developed.

The Government will be publishing a progress report, in Summer 2014, to highlight progress across this agenda. We hope to be able to point to how government has taken forward the recommendations, and also how well companies and investors have stepped up to the plate.

I warmly welcome the report and am grateful to Professor Kay, his Advisory Board and all those who contributed to this important review.



Vince Cable

Secretary of State, Department for Business, Innovation and Skills

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1. Executive Summary

1.1 The Government welcomes the final report of the Kay Review.[1]

1.2 In his report Professor Kay sets out a number of principles and directions which he suggests should provide the foundation for future developments in public and regulatory policy and market practice in the investment chain.

1.3 **Chapter 2** below explains why the Government accepts Professor Kay's analysis and the conclusions of his report. The Government endorses ten **principles for equity markets** to which market practitioners, government and regulatory authorities should have regard. It supports the **directions for market participants** which follow from these principles. The Government will also work with 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.

1.4 Professor Kay also makes 17 more **specific recommendations** – aimed variously at market participants, government and regulatory authorities – which are the first steps towards ensuring that UK equity markets fulfil their core purposes. **Chapter 3** sets out the Government's detailed response to each of the specific recommendations, making clear what steps the Government is taking to deliver these, and where they are engaging with business and investment industry stakeholders to encourage them to take the lead.

1.5 A number of measures are already in place which contribute to the delivery of Professor Kay's recommendations, including:

- Progress with the Government's proposals to reform corporate narrative reporting[2] to be higher quality, simpler, more relevant to users and more focussed on forward looking strategy – to come into force from 1 October 2013;
- A renewed commitment to secure reforms to the EU Transparency Directive which will remove mandatory quarterly reporting;
- An updated edition of the Financial Reporting Council (FRC) Stewardship Code which emphasises that stewardship should encompass questions of company strategy – in line with Kay's recommendation.[3]

1.6 The Government is also supportive of Professor Kay's Good Practice Statements for Company Directors, Asset Managers and Asset Holders (Annexes A – C), and believes they should prompt market participants to consider their current practice, such that industry-led standards of good practice emerge. The Government is asking relevant

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[1] The Kay Review of UK Equity Markets and Long-term Decision Making: Final Report, July 2012, available at: http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf
[2] The Future of Narrative Reporting, BIS website: http://www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation?cat=closedwithresponse
[3] The Stewardship Code, FRC Website, September 2012: http://frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx

business representative groups and investment industry trade associations to review Kay's Good Practice Statements, signal to what extent they can endorse them and suggest how good practice standards might be further developed. We have been encouraged by the constructive and positive discussions we have had with a number of organisations. We look forward to these and other groups responding to this challenge.

1.7 The Good Practice Statements advocate, among other things, more collective action by institutional shareholders, better disclosure of costs in the investment chain, transparency and fairness around the lending of securities, and better alignment between pay and long-term performance for company directors and asset managers. We see promising signs that market participants are responding to the challenge in each of these areas, but we believe more progress is required.

1.8 Professor Kay's report sets a long-term vision for UK markets that will create growth and jobs, and meet the needs of businesses and investors in the UK and globally. This will require sustained commitment. As part of this, the Government will publish an update, in Summer 2014, setting out what further progress has been achieved, by government and by others, to deliver Professor Kay's specific recommendations. It will also provide an update on work by the Government and regulatory authorities to take forward Professor Kay's directions for regulatory policy.

2. Kay Principles and Directions

2.1 This chapter sets out the Government's view on Professor Kay's analysis and suggested principles for UK equity markets – and the directions which he proposes should follow from these principles – for market participants and for regulatory policy makers.

Kay's Analysis and Principles for Equity Markets

2.2 Professor Kay's analysis of the problems of short-termism in UK equity markets focuses primarily on the nature of relationships which arise between market participants, and the incentives they face. He characterises the underlying causes of these problems as the decline of trust and the presence of misaligned incentives in these relationships. No blame attaches to particular groups in the investment chain.

2.3 Professor Kay finds equity investment has become increasingly intermediated. He acknowledges that this has in part been driven by a desire for greater professionalism and efficiency through specialisation, but he also suggests that it has in part been a response to the decline in trust and confidence in the investment chain. His concerns are essentially twofold: first that the costs of intermediation have become excessive relative to the benefits, and second that the increase in intermediation creates the potential for misaligned incentives and principal-agent problems. The Government believes these concerns are valid.

2.4 Accordingly, he proposes solutions to these problems which focus on building relationships of trust and confidence in the investment chain and creating incentives to act in ways which support good long-term decision making by companies. The Government supports this approach.

2.5 We recognise that historically equity markets have existed to meet the needs of two differing groups of customers: investors and companies.

Investors

2.6 Investors invest for a purpose. This will affect how much they invest in shares, and how much in other sorts of investments; and also potentially decisions on whether to invest (or not) in particular sorts of companies. It will also determine how much certainty they need, and their investment timescale. Differing investors will also be operating within differing legal frameworks, and constraints. The UK's position as a global market means that increasingly investors will be overseas investors, operating to frameworks set overseas. Self-evidently, the person actually making the investment decisions can only reflect investors wishes if they know what they are.

2.7 Professor Kay therefore seeks to define minimum standards of behaviour for those investing on behalf of others, and those advising on such investment decisions. He considers such standards as the necessary basis for relationships based on trust and confidence in the investment chain. The Government supports this objective. To that end Professor Kay proposes the following principle:

All participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers. Fiduciary standards require that the client's interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed. These standards should not require, nor even permit, the agent to depart from generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards.

2.8 Since the Kay Report was published there has been a great deal of discussion of the meaning and scope of the word "fiduciary". Many interpret it in the strict legal sense of a relationship in which the principal is reliant or dependent on the knowledge, expertise and discretion of an agent, and to which the strictest duties of loyalty and prudence are applicable. Others however use of the word fiduciary to describe a more general duty of care. In order to provide clarity that these standards should apply universally, the Government has therefore elected to avoid using the word "fiduciary". The Government believes that it would be appropriate to instead adopt the following principle for equity markets, which reflects Kay's Good Practice Statements for Asset Managers and Asset Holders:

All participants in the equity investment chain should act:

- *in good faith;*
- *in the best long-term interests of their clients or beneficiaries;*
- *in line with generally prevailing standards of decent behaviour.*

This means ensuring that the direct and indirect costs of services provided are reasonable and disclosed, and that conflicts of interest are avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary.

These obligations should be independent of the classification of the client.

They should not be contractually overridden.

2.9 Professor Kay also sets out two policy directions which follow from his proposed principle:

- *Regulatory obligations in the equity investment chain should be raised to fiduciary standards;*
- *The application of the legal concept of fiduciary duty to investment matters should be clarified.*

2.10 These directions are reflected in his Recommendations 7 and 9 respectively. The Government accepts the thrust of these recommendations, and has clarified precisely how they will be taken forward, with reference to the above principle, in Chapter 3.

2.11 Professor Kay stresses in particular the importance of relationships of trust and confidence between companies and their shareholders – strongly supporting the concept of stewardship. He describes company directors as stewards of their companies, and emphasises that their duty to promote the success of the company, as defined in Companies Act 2006, requires that they make decisions with regard to the long-term consequences.

2.12 Moreover, his position that stewardship should be broadly understood to include engagement on aspects of company strategy (rather than simply on compliance with corporate governance standards) reflects the Government's view, and indeed that of the FRC, emphasised in their recent update to the Stewardship Code. The Government believes and welcomes the fact this view is also shared by many directors. The business models of some companies are inevitably very long term, and self-evidently engagement with company strategy means investment managers being prepared to look that far ahead. The Government shares the disappointment of some directors that investors can on occasions be unwilling to look more than a couple of years at most ahead – this cannot be a sensible basis on which to engage on a strategic discussion.

Companies

2.13 Professor Kay finds that the public equity markets are not currently a significant source of finance for new investment for many UK companies, who typically fund new projects from retained earnings. He concludes that as a result the principal current function of UK public equity markets is to oversee the use of capital within companies – that is to ensure good governance and decision making by company executives – rather than to allocate capital between companies.

2.14 The Government notes this conclusion, but we believe that public equity markets should not be dismissed as a means for businesses to raise new finance for investment, not least because equity capital provides greater flexibility against losses. Professor Kay acknowledges this, stating that;

> *"we believe that our recommendations to encourage asset managers to act as long-term stewards of more concentrated, less liquid equity portfolios will mean a greater willingness to invest funds across a broader range of companies, including smaller businesses who wish to raise equity finance, but are currently unable to do so".*

2.15 Moreover, as Professor Kay acknowledges, public markets can provide a mechanism for earlier stage investors to exit. Their efficacy in this respect will therefore influence the decisions of those seeking to invest in private companies, which might in due course become publicly-traded. The Government believes that all businesses should be able to raise the finance they need and has made a number of interventions in financial markets to help increase access to finance for British companies.[4] Professor Kay's analysis provides useful insights in this context.

2.16 Some commentators have questioned whether shareholder stewardship contributes value to the operation of a company, highlighting the difficulty of establishing conclusive evidence of such a beneficial relationship. Professor Kay is clear it is the quality of the relationship, not the amount of engagement, which is important. He does not suggest

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[4] Access to Finance, BIS Website: http://www.bis.gov.uk/policies/enterprise-and-business-support/access-to-finance

that shareholders should be involved in managing companies day-to-day, but rather that a stewardship relationship based on an understanding of company fundamentals creates an environment of trust and constructive challenge which enables those managing the company to take good long-term decisions on investment and strategy.

2.17 Kay characterises this approach as ‘investing’, and contrasts it with ‘trading’ on the basis of expected short-term movements in a company’s share price. He acknowledges that this distinction is not clear cut, and does not suggest that investors should never buy and sell shares, nor that they should not take the market price of those shares into account in their decision to do so, but simply that their approach should be based on a long-term view of the underlying capacity of the business to deliver returns. Indeed he makes clear that the trading of shares is necessary for markets to be liquid and efficient: to allow savers and companies to invest on different timescales. But he also demonstrates that investment strategies based on trading to benefit from expected share price movements cannot improve the underlying performance of companies, and can instead create incentives on company executives which undermine long-term value creation. ‘Trading’ is about allocating portions of the cake, while ‘investing’ is about growing the size of the cake overall. The Government believes this analysis has merit.

2.18 Professor Kay highlights a particular problem in the way investors judge the performance of active asset managers, suggesting that this is one of a number of cases where metrics and models used in the investment chain to assess value, performance or risk are of little relevance to the creation of long-term value in companies and can distort behaviour towards an excessively short-term focus. He observes:

> *“The appointment and monitoring of active asset managers is too often based on short-term relative performance. The shorter the timescale for judging asset manager performance, and the slower market prices are to respond to changes in the fundamental value of the company’s securities, the greater the incentive for the asset manager to focus on the behaviour of other market participants rather than on understanding the underlying value of the business. But competition between asset managers on the basis of relative performance is inherently a zero sum game. The asset management industry can benefit its customers – savers – taken as a whole, only to the extent that its activities improve the performance of investee companies. This conflict between the imperatives of the business model of asset managers, and the interests of UK business and those who invest in it, is at the heart of our analysis of the problem of short-termism.”*

2.19 Professor Kay also observes that some active asset managers, faced with the need to deliver short-term relative performance, will resort to ‘closet indexing’, i.e. selecting and managing their equity portfolio to minimise tracking error from their performance benchmark. Professor Kay suggests such portfolio over-diversification is a further disincentive to engagement and argues that if active asset managers believe that their investment style can add value then they should typically have portfolios which are more differentiated from each other and from benchmark indices.

2.20 Professor Kay highlights the need for asset holders to issue mandates for active asset managers which set targets to achieve <u>absolute returns</u> in line with investment objectives and time horizons of the beneficiaries rather than short-term <u>relative performance</u> objectives. 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 to fostering long-term engagement between asset managers and company directors. We hope the Good Practice Statement for Asset Managers provides a useful tool for asset holders to promote appropriate behaviour on the part of the asset managers they appoint.

2.21 Not all asset managers will, or should, offer active management: passive asset management should continue to have a role in the market. In his interim report[5] Professor Kay pointed out that passive managers by their nature can have clear incentives to embrace stewardship and to take a long-term view as they have no option to 'exit' companies which continue to make up the index they track. He noted that many of the large passive asset managers already practice long-term stewardship investing. He therefore proposed in his final report that passive managers should recognise a special responsibility to improve the performance of the index they track through engaged ownership. In this context he highlights the importance of investors understanding the make-up of the index including appreciating the risk that indices may have little relevance to their underlying objectives. He welcomes the fact that asset managers are increasingly looking to construct fundamental indices, or actively selecting equity portfolios to offer as passive funds over a very long time horizon.

2.22 Overall, the Government accepts Professor Kay's analysis. On that basis we believe that the principles listed below, which reflect that analysis, provide a sound foundation for a long-term perspective in equity markets, as the report proposes. **The Government therefore:**

- **will have regard to these principles in future development of policy and regulation;**
- **asks relevant regulatory authorities to consider how they inform the future development of regulatory policy; and**
- **calls upon market practitioners to have regard to these principles, including when developing good practice.**

[5] The Kay Review of UK Equity Markets and Long-term Decision Making: Interim Report, February 2012, available at: http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-631-kay-review-of-equity-markets-interim-report.pdf

Principles for Equity Markets

1. All participants in the equity investment chain should act according to the principles of stewardship, based on respect for those whose funds are invested or managed, and trust in those by whom the funds are invested or managed.
2. Relationships based on trust and respect are everywhere more effective than trading transactions between anonymous agents in promoting high performance of companies and securing good returns to savers taken as a whole.
3. Asset managers can contribute more to the performance of British business (and in consequence to overall returns to their savers) through greater involvement with the companies in which they invest.
4. Company directors are stewards of the assets and operations of their business. The duties of company directors are to the company, not its share price, and companies should aim to develop relationships with investors, rather than with ‘the market’.
5. All participants in the equity investment chain should act in good faith, in the best long-term interests of their clients or beneficiaries, and in line with generally prevailing standards of decent behaviour. This means ensuring that the direct and indirect costs of services provided are reasonable and disclosed, and that conflicts of interest are avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary. These obligations should be independent of the classification of the client and should not be contractually overridden.
6. At each stage of the equity investment chain, reporting of performance should be clear, relevant, timely, related closely to the needs of users and directed to the creation of long-term value in the companies in which savers’ funds are invested.
7. Metrics and models used in the equity investment chain should give information directly relevant to the creation of long-term value in companies and good risk adjusted long-term returns to savers.
8. Risk in the equity investment chain is the failure of companies to meet the reasonable expectations of their stakeholders or the failure of investments to meet the reasonable expectations of savers. Risk is not short-term volatility of return, or tracking error relative to an index benchmark, and the use of measures and models which rely on such metrics should be discouraged.
9. Market incentives should enable and encourage companies, savers and intermediaries to adopt investment approaches which achieve long-term returns by supporting and challenging corporate decisions in pursuit of long-term value.
10. The regulatory framework should enable and encourage companies, savers and intermediaries to adopt such investment approaches.

Kay's Directions for Market Practice and Regulatory Policy

2.23 Following from the principles above, Professor Kay identifies a series of directions in which he suggests market practice and regulatory policy should move.

2.24 The table below lists those **directions which are relevant for market participants**. These should also inform the development of good practice in the equity investment chain and the financial markets more widely. They are reflected in Kay's Good Practice Statements for Company Directors, Asset Managers and Asset Holders, and many of the other specific recommendations, discussed in detail in Chapter 3 of this response, also advance these directions.

Directions for Market Participants:

- Agents at each stage of the equity investment chain should review their practices with a view to establishing more effective working relationships based on trust and respect.
- Asset managers should have greater incentives to engagement. Active asset managers should typically have more concentrated portfolios which are more differentiated from each other and from benchmark indices.
- There should be more opportunity for collective action by asset managers who should have greater freedom to act collectively without fear of regulatory consequences.
- Passive managers should recognise a special responsibility to improve the performance of the index they track.
- British business should emphasise the creation and maintenance of competitive advantage in operating businesses, which is the only long-term source of shareholder value. Investors should support this objective.
- Asset managers should increasingly negotiate, individually and collectively, the provision of the information they need to make good long-term decisions.
- Noise in information – the frequent reporting of data irrelevant to long-term value creation – should be reduced.
- Information providers and all involved in the equity investment chain should recognise that no single metric or model can provide a sure guide to long-term value in companies or equity portfolios.
- The use of measures which are not related to long-term value creation should be discouraged by users.
- Any bonuses paid in the equity investment chain should be closely related to the agent's performance in determining long-term value, and the ability to realise the value of the bonus should be related to the realisation of that long-term value.
- Rewards should reflect long-term value creation rather than the amount or volume of transactions.

2.25 Following from the principles he advocates, Professor Kay also proposes a number of **directions for regulatory policy.** The table below lists these directions in full:

Directions for Government and Regulators:

- Regulatory practice should favour investing over trading, not the other way round.
- Regulatory discouragements to asset managers having more concentrated portfolios which are more differentiated from each other, and from benchmark indices, should be reduced or removed.
- There should be more opportunity for collective action by asset managers who should have greater freedom to act collectively without fear of regulatory consequences.
- Regulation should adopt the perspective and interests of market users, not market intermediaries. Market users are companies and savers.
- Regulation should emphasise issues of structure and incentives rather than control of behaviour.
- Regulation should not be based on the assumption that markets will achieve efficient outcomes if supplied with sufficient information, but whenever possible address policy objectives directly.
- Regulation should be more consumer focussed, emphasise and promote simple products and trusted providers, stressing product suitability and supplier integrity.
- Government and regulatory policy should aim to ensure that there are no unnecessary disincentives to using equity markets, either for companies or for their investors.
- Regulatory requirements based on inappropriate metrics which discourage equity investment should be reviewed.
- Relevance to investors should be the principal criterion in determining reporting obligations.
- Noise in information – the frequent reporting of data irrelevant to long-term value creation – should be reduced.
- Regulators should recognise that no single metric or model can provide a sure guide to long-term value in companies or equity portfolios.
- The use of measures which are not related to long-term value creation should be discouraged by regulators.
- Risk is not short-term volatility of return, or tracking error relative to an index benchmark, and the use of measures and models which rely on such metrics should be discouraged.

2.26 The Government believes that, in a number of important areas, regulatory policy is already developing in ways which are consistent with these directions. For example:

- The Government's reforms to corporate narrative reporting are aligned with the direction to emphasise relevance to investors in reporting obligations. 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 them into force in October 2013.[6]

- Both the Takeover Panel and the Financial Services Authority (FSA) have previously acted to reassure shareholders that their rules are not intended to prevent collective engagement with the management of an investee company. The Government supports this view.

- The rule changes resulting from the FSA's Retail Distribution Review (RDR), which aim to improve clarity for retail investors and reduce the conflict of interest which currently arise from the remuneration of financial advisers, will come into force from the end of the year. As the report acknowledges, the RDR's emphasis on market structure and incentives is very much in line with the directions for regulatory policy.

- The new Financial Conduct Authority (FCA) has consumer protection as one of its operational objectives, and includes among the desired outcomes of its regulatory approach that consumers get financial services and products that meet their needs, from firms they can trust; which will in turn create the expectation that firms place the interests of customers and the integrity of the market at the heart of their business. In setting out the regulatory approach of its successor organisation, the FSA has made clear that there will be a greater emphasis on product design, governance and suitability. These developments align with Professor Kay's direction that regulation should be more consumer focussed, emphasise and promote simple products and trusted providers, stressing product suitability and supplier integrity.

- The Pension Regulator's (TPR) regulatory strategy for defined contribution pension schemes is focussed on supporting the market to deliver good outcomes for scheme members by encouraging good quality provision. TPR acknowledges that many members of DC schemes are not sufficiently financially literate or engaged, and that information provision alone will not enable such outcomes. In such circumstances TPR's regulatory approach focuses on effective scheme governance and administration, and clear accountability for those acting in members' interest. Again this approach aligns with the relevant directions for regulatory policy.

2.27 More generally, many of the directions for regulatory policy have potentially wide-ranging implications across the regulation of financial services and markets, pensions, and corporate accounting and reporting. It is therefore important that the relevant government departments and independent regulators have the opportunity to consider them in more detail. One of the specific recommendations of the Kay Report (Recommendation 14) prompts similarly broad questions. It proposes that:

> *"Regulators should avoid implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgement"*.

2.28 The Government will undertake further work to identify to what extent these directions are practical, what changes in the law or in regulation might be therefore be appropriate,

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[6] The Future of Narrative Reporting, BIS website: http://www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation?cat=closedwithresponse

and how these can best be delivered. It will also be important to consider how the findings of the Kay Report should inform the UK's position with respect to EU regulatory policy.

2.29 This work will be taken forward jointly by Government (in particular the Department for Business, Innovation and Skills, HM Treasury, the Department for Work and Pensions, and the Cabinet Office) and relevant regulators (the Financial Reporting Council, the Financial Conduct Authority, the Prudential Regulatory Authority, the Pensions Regulator, and the Bank of England).

2.30 The Government will report on the progress of this work, and how the Kay Report is being used to inform future policy development, in Summer 2014.

3. Government Response to Specific Recommendations

3.1 The Government's detailed response to the 17 specific recommendations in the Kay Report is set out below.

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.

3.2 The Stewardship Code is the responsibility of the FRC, the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment.

3.3 The FRC published a revised edition of the Stewardship Code in September 2012.[7] The introduction to the new edition of the Code clarifies the aim and definition of stewardship, strengthening previous references in the 2010 edition to engagement by institutional investors on matters of company strategy.

3.4 The revised Stewardship Code makes clear that the concept of stewardship is a broad one: good stewardship by institutional investors goes beyond simply monitoring companies' compliance with the Corporate Governance Code. The update to the Stewardship Code therefore demonstrates that the FRC's view of the developing nature of stewardship is similar to, and informed by, that set out in the Kay Report.

3.5 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.

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.

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[7] The Stewardship Code, FRC Website, September 2012: http://frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx

3.6 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.

3.7 As Professor Kay comments: "*Trust and respect cannot be established by regulation… The most powerful mechanism for establishing a culture of trust and respect is for intermediaries and market participants to impose it on each other."*

3.8 These documents will not have the force of regulation or formal guidance, but they should prompt market participants to consider their current practice, and inform industry-led standards of good practice.

3.9 The Government is asking relevant business representative groups and investment industry trade associations to review Kay's Good Practice Statements, signal to what extent they can endorse them and suggest how good practice standards might be further developed. We have been encouraged by the constructive and positive discussions we have had with organisations including the Confederation of British Industry (CBI), the Quoted Companies Alliance (QCA), the GC100 Group of general counsel and company secretaries of FTSE 100 companies, the Investment Management Association (IMA), the Chartered Financial Analysts Society of the UK (CFA UK), the Association of Investment Companies (AIC), the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) about the Kay Report, and look forward to these and other groups responding to this challenge.

3.10 Since the Kay Report was published we have also seen a number of encouraging examples of market participants collaborating to develop good practice in the field of engagement and stewardship, prompted in part by the Kay Report. For instance:

- The Institute of Chartered Secretaries and Administrators (ICSA) has established a steering group at the request of the 2020 Investor Stewardship Working Group to take forward two of the recommendations from its report: *Improving the Quality of Investor Stewardship*. [8] These recommendations were to develop a good practice guide to improve the quality of engagement activity, and to identify more effective means for companies and institutional investors to provide feedback on the quality of meetings. The Group, which includes representatives from leading UK companies and institutional investors, published a consultation document on 19 October 2012.[9]

- The Foundation for Governance Research and Education (FGRE) has launched a project, in association with several asset management firms, to build on its 2011 Report – An Investigation into Stewardship. The project is exploring the stewardship

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[8] Available at Tomorrow's company website: http://tomorrowscompany.com/2020-stewardship-improving-the-quality-of-investor-stewardship-the-report-3

[9] Available at the ICSA website: http://www.icsaglobal.com/about-icsa/latest-from-icsa/article/stewardship-consultation-launched

obligations of asset managers and will use case studies to provide guidance on engagement good practice. A report is expected by the end of the year.[10]

3.11 In line with the second part of this recommendation, the FCA, FRC and TPR will consider to what extent existing regulatory requirements may prevent the adoption of standards of good practice as defined in the Good Practice Statements, and what steps might be appropriate to enhance existing regulatory guidance and codes of practice accordingly. The Government's progress report in Summer 2014 will include an update on these considerations.

Recommendation 3:

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

3.12 The Government agrees that an investors' forum should be established as a mechanism for collective action by investors, to help overcome disincentives on institutional investors to constructive engagement with companies.

3.13 We support Professor Kay's view that the forum would need to be relatively flexibly constituted *"to accommodate general discussion of issues of company strategy and corporate governance, and also specific issues arising at particular companies",* and to enable a mixture of asset managers and asset holders to be involved.

3.14 The increasingly globalised nature of markets for the provision of capital and in investment services means that overseas institutions have significant shareholdings in many UK public companies. The Government acknowledges that many such investors have long-term investment objectives and would welcome their involvement in the investors' forum.

3.15 The Government agrees with Professor Kay's view that it is extremely unlikely that collective action of the sort which the forum would facilitate would trigger a mandatory bid under the Takeover Code. As noted in the Kay Report, the Takeover Panel issued a Practice Statement in 2009, confirming that "*the relevant provisions of the Code have neither the intention nor the effect of acting as a barrier to co-operative action by fund managers and institutional shareholders, or of constraining normal collective shareholder action*".[11]

3.16 We know that many investors already act collectively and we have no wish to undermine this. Nor do we wish to discourage existing representative bodies from facilitating collective engagement. Nonetheless, we have had informal discussions with a variety of institutional investors to understand their views and preferences and found general support for the creation of a new forum.

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[10] More details available at FGRE website: http://www.foundationgre.com

[11] The Takeover Panel, Practice Statement No. 26: Shareholder Activism, September 2009, available at: http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/ps26.pdf

3.17 Since the publication of the Kay Report, we have seen encouraging signs that major institutional investors and industry bodies are considering how they might improve collective engagement. We welcome these developments as the first steps to delivering this recommendation, and would like to see further progress across the investment industry.

3.18 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.

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.

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

3.20 We acknowledge the concerns Professor Kay raises. His report highlights in particular the tendency of some companies to place too great an emphasis on acquisitions relative to developing competitive advantage of their existing business operations, and argues that short-term economic incentives on market participants towards action (notably those advising companies on takeover activity) have also led to mergers and acquisitions which have destroyed long-term value for investors.

3.21 Professor Kay is rightly cautious in his response to these concerns. He argues against a general hostility to foreign ownership – acknowledging the continued importance of open markets for growth. The Government supports this conclusion and is committed to open markets – we believe that direct investment by foreign companies can bring in new ideas, technologies and skills to the UK, stimulating productivity and growth in UK firms and opening up new markets for trade.

3.22 We also agree with Professor Kay's assertion that the most important step to ensuring that mergers and acquisitions involving UK companies deliver long-term value is a change in the culture of market participants which enables company boards to make better informed decisions – based on engagement with their shareholders who are more prepared to question ambitious takeover proposals as part of their stewardship role. He emphasises that the wider recommendations of his report should contribute to this objective.

3.23 We agree, and in particular would emphasise the call in the report's Good Practice Statement for Company Directors to *"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".*

3.24 The Government also supports the clear view expressed by Professor Kay that the duty of company directors to promote the success of the company for the benefit of its members, as defined in Companies Act 2006, requires that decisions be made with regard to the long-term. In the context of takeovers this means that company directors can recommend to shareholders that they reject a bid at premium to the pre-bid share price if they believe that the transaction will destroy value in the longer term, or that the premium does not reflect the fundamental value of the company. The emphasis placed on this duty in Professor Kay's Good Practice Statement for Company Directors is also welcome.

3.25 This complements the clarification from the Takeover Panel, in its October 2011 revisions to the Takeover Code, that a company board is not bound to consider the offer price as the determining factor in giving its opinion on an offer and may consider other factors. The Government has welcomed the revisions to the Takeover Code which aimed to strengthen the position of target companies in the face of unwelcome takeovers, including by:

- increasing the protection for target companies against protracted 'virtual bid' periods by requiring the company to be named in an initial announcement which then triggers a 28-day time limit in which the company must make a final offer or withdraw, unless an extension is agreed;

- strengthening the position of the target company by banning deal protection measures and inducement fees other than in certain limited cases;

- increasing transparency and improving the quality of disclosure, by requiring the disclosure of offer related fees, and all documents relating to the financing for the offer to be put on public display;

- providing greater recognition of the interests of target company shareholders and employees through improving disclosure by both companies of the acquirer's intentions and by improving the ability of employee representatives to make their views known; and

- requiring that statements of intention must now be adhered to during the time it takes to implement them (or for 12 months, if no time is given) unless there is a material change of circumstances.

3.26 Professor Kay does suggest that the Government and regulatory authorities could be more active in their approach to mergers and acquisitions, in particular by using existing powers and informal authority to discourage acquisitions, or to seek assurances from the parties involved, where they identified significant risks to the effective management of the company or to its operations in the UK. The Government believes it would be appropriate for government to take a greater interest in mergers and acquisitions, and it will engage with companies and their investors, including in the context of its Industrial Strategy, to promote investment which benefits the UK economy.

3.27 The Government has also been considering how the new Competition and Markets Authority (CMA) can best support long-term economic growth, and how this can be best reflected in its performance framework. The Government has already committed to consulting, once a Parliament, on a high-level strategic steer for the CMA which will outline the long-term goals of the Government in relation to competition and growth.

Recommendation 5:

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

3.28 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.

3.29 We believe Recommendation 5 represents good practice for companies. This recommendation has therefore been appended to the Good Practice Statement for Company Directors published alongside this response.

3.30 The Government notes that the existing provisions of the Corporate Governance Code relating to the effectiveness of companies' boards and their relations with shareholders are consistent with such consultation.[12] The FRC will wish to consider whether there is a need for more detailed or explicit guidance on this practice when considering how the Corporate Governance Code should develop – including to align with the Kay Good Practice Statement for Company Directors (see paragraph 3.11 above).

Recommendation 6:

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

3.31 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.

3.32 We do not believe Professor Kay is suggesting that companies should not meet their obligations to disclose relevant information to investors or the market. Rather, Professor Kay's concern is that companies may face incentives to manage their businesses so as to avoid short-term share price volatility, rather than focusing on delivering value over the long term. He highlights the incentives on sell-side analysts to anticipate and interpret company statements in a way which promotes short-term trading in a company's shares rather than an understanding of the fundamentals of the company, and the incentives on investors with short-term performance targets to react to such

[12] The UK Corporate Governance Code, FRC website: http://frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx

analysis rather than focus on the company's ability to generate value over the long term. He argues this puts pressure on companies to manage the short-term expectations of the market, rather than sharing their long-term vision for the company. He suggests these incentives can only be overcome by developing relationships based on trust between companies and investors which allow companies to disclose information in the context of an understanding of long-term strategy.

3.33 This recommendation chimes with Professor Kay's wider principle that directors have a duty to the company and not the share price, and should aim to develop relations with investors rather than the market. It also complements the Good Practice Statement for Company Directors.

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.

3.34 As discussed in Chapter 2, 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, and has therefore defined these standards in the following principle:

All participants in the equity investment chain should act:

- *in good faith;*
- *in the best long-term interests of their clients or beneficiaries;*
- *in line with generally prevailing standards of decent behaviour.*

This means ensuring the direct and indirect costs of services provided are reasonable and disclosed, and that conflicts of interest are avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary.

These obligations should be independent of the classification of the client.

They should not be contractually overridden.

3.35 The Government welcomes the industry-wide support for this principle. In addition, the Government has asked the FSA, and its successor organisation the FCA, to consider to what extent current regulatory rules in this area align with this principle, with particular reference to the issues raised in the Kay Report around conflicts of interest requirements and contractual mechanisms to limit the obligations of intermediaries, to determine what action might be desirable.

3.36 We note that the current regulatory rules in this area are substantially influenced by harmonised EU legislation, and that changes to regulatory requirements at EU level may therefore be desirable.

Recommendation 8:

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

3.37 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.

3.38 Since the Kay Review was commissioned, the issue of greater transparency on fees and charges in the investment chain has been the subject of increasing public debate. Particular emphasis has been placed on improving disclosure of transaction costs by asset managers on investment funds, and on ensuring there is greater clarity about the costs and charges levied on defined contribution pension schemes. This debate has been driven by concerns about charges on pensions and similar long-term savings products, and the new requirements on employers to automatically enrol their employees into a pension scheme.

3.39 We see some evidence that the investment and pensions industries have responded to this debate, with new initiatives on cost transparency from the Investment Management Association (IMA), the National Association of Pension Funds (NAPF) and the Association of British Insurers (ABI). We welcome these initiatives and, like Professor Kay, are optimistic that they represent progress towards an industry-led disclosure regime which provides comprehensive, clear, comparable information on costs and charges to all savers irrespective of their choice of investment vehicle. We believe that this sort of collaborative, industry-led approach is likely to be best placed to resolve technical questions on disclosure – for instance on how best to calculate and present transaction costs in a way which is meaningful.

3.40 Professor Kay suggests the Government should consider regulatory measures if the industry does not arrive at an appropriately comprehensive disclosure regime. Any such measures would need to be agreed at EU level given the maximum harmonisation requirements of the European Directives in this area. 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.

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.

3.41 This recommendation seeks to address concerns that some investment intermediaries are interpreting their duties to their clients or to beneficiaries too narrowly to mean the duty to maximise short-term financial returns, and that this may lead them to set investment strategies with asset managers that focus on short-term performance metrics, create a disincentive to engagement, and do not take into account long-term factors including relevant environmental, social and governance factors which may be relevant to company performance. Others have suggested that such an interpretation is a barrier to social investment. Kay suggests such an interpretation may be the product of advice – from lawyers and consultants – that seeks to protect the intermediary rather than to support them to act in the best interest of the client or beneficiary.

3.42 We agree with Professor Kay that those investing on behalf of others, and those advising on such investment decisions (whether or not they are subject to fiduciary duties) should take into account long-term factors relevant to their clients' interests over the time horizon of the investment. An investment intermediary should not automatically assume that maximising short-term returns is sufficient to serve their clients' interests.

3.43 As Professor Kay writes:

> *"Asset holders and asset managers ought to match their advice to the risk preferences and time horizons of ultimate beneficiaries: subject to that requirement they should adopt investment policies which maximise absolute long-term investment returns: they should invest in line with generally prevailing ethical standards and take account of any specific wishes of their beneficiaries: but they should not use their position to advance political goals or other objectives not directly related to the welfare of their beneficiaries. Their duties are to all their beneficiaries but not to savers at large if they are not beneficiaries of the particular trust to which the trustee has obligations. This approach would not require, or even permit, asset holders or asset managers to depart from generally prevailing standards of decent behaviour even if such behaviour would be in the narrow financial interest of the beneficiary."*

3.44 The Government therefore 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.

3.45 We believe it would also be helpful to seek clarification of whether the law allows for any differentiation of investment duties to reflect the different nature of particular classes of trustees, and in particular, whether investment duties allow charity trustees to take any account of social benefits that relate to their charity's purpose as well as financial benefit. This clarification will assist the Government in considering specific recommendations relating to the investment duties of charity trustees made by Lord Hodgson in his review of the Charities Act 2006.[13]

Recommendation 10:

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

3.46 The Government agrees that stock lending activity should not bring about misaligned incentives for asset managers or other intermediaries, and therefore supports this recommendation.

3.47 Existing practice typically involves asset managers or other intermediaries, such as custodians, lending stock on behalf their clients. As Professor Kay identifies it is common for these intermediaries to retain some of the income generated from the activity as a fee for the activity, while the risk with stock lending typically remains with the fund whose stock is lent (and therefore typically with the ultimate saver). This creates an incentive to lend stock for the intermediary's own benefit rather than the benefit of the client. In some cases stock may be lent at more than one point in the investment chain. Because of the intermediated nature of the investment process, the client may have little visibility over whether the lending of stock is in their interest or whether the fee charged is proportionate to the costs and risks they have incurred. Moreover, income from stock lending is not usually disaggregated from figures showing the performance of the fund overall, while the costs incurred are not usually separated from the overall ongoing management charge. The client therefore has little scope to judge whether the costs and risks of the stock activity justify the income it generates.

3.48 We believe that the best way to address these problems is for asset managers and other intermediaries undertaking stock lending to disclose separately both the total income generated for their client from stock lending and any costs associated with undertaking the activity.

3.49 This recommendation is reflected in the Good Practice Statement for Asset Managers, signalling Professor Kay's intention to improve behaviour through the development of industry good practice, rather than by imposing regulatory requirements.

3.50 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.

[13] *Trusted and Independent: Giving Charity Back to Charities, Review of the Charities Act 2006*, available at: http://www.cabinetoffice.gov.uk/resource-library/trusted-and-independent-giving-charity-back-charities-review-charities-act-2006

Recommendation 11:

Mandatory IMS (quarterly reporting) obligations should be removed.

3.51 The Government supports this recommendation. Mandatory quarterly reporting is currently a requirement of the EU Transparency Directive, implemented in the UK by the FSA. However, since the Kay Review was commissioned, the European Commission has brought forward proposals to amend the directive, including by moving away from mandatory requirements on companies whose shares are admitted to trading on a regulated market to produce interim management statements on a quarterly basis. The stated objectives of the Commission's proposal are both to reduce the regulatory burden of reporting for these companies and to address concerns that rigid quarterly reporting requirements may be promoting a short-term focus by companies, investors and market intermediaries.

3.52 The Government has already made clear its strong support for the Commission's proposal 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.

Recommendation 12:

High quality, succinct narrative reporting should be strongly encouraged.

3.53 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 first exercise sought evidence of the problems with the existing narrative reporting regime and the second, building on this evidence, proposed a new format for company reports. The proposed new format would create a separate strategic report as the first place investors would go to find the key information they need. We have also proposed removing some disclosure requirements altogether.

3.54 The findings of these consultation exercises support Professor Kay's view that succinct reporting is important. Longer reports are not necessarily more informative, and can even become an obstacle to transparency and understanding for readers. As well as legislating to improve narrative reporting, through changing the structure and some of the content of reports, we will work with the FRC as it reviews the current guidance and works to improve the quality of financial reports. It will aim to give companies the confidence to report only what they need to without adding unnecessary material that does not add to a reader’s understanding of a company.

3.55 Kay recognises the role that shareholders have in shaping reports. The Government believes that dialogue between investors and companies is a powerful means to improve the quality of reporting. In turn, more focused reports, with strategy at the forefront, will improve the quality and value of the dialogue not only about reports, but also about the future direction of the company.

3.56 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.[14] We will be working closely with the FRC as they develop the guidance on the new provisions.

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.

3.57 The Government welcomes the Kay Report's focus on ensuring that metrics and models used in the investment chain give information which is relevant to the creation of long-term value by companies and good risk-adjusted returns to savers. This recommendation is very broad in scope, and potentially includes consideration of the metrics and models which are commonly used to assess the performance of companies, and forecast their future performance, as well as those used to assess risk and likely return in the formation of investment strategies. It raises questions about to what extent such metrics and models are influenced by short-term market fluctuations, or whether they provide information relevant to understanding the company's capacity to generate economic value over the long term.

3.58 We agree with Professor Kay that a greater understanding of the uses and limitations of different metrics and models would be beneficial both to market participants and to regulatory authorities. We do not believe however that the Government is best placed to conduct or commission a review in this area, given the technical nature and broad scope of the issues involved.

3.59 The Government will therefore explore with market participants, the regulators, academics and relevant representative and professional bodies how best to stimulate more debate and economic analysis in this area. We expect to set out further proposals early in the new year.

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.

3.60 As set out in Chapter 2 of this response, 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.

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[14] The Future of Narrative Reporting, BIS website: http://www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation?cat=closedwithresponse

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.

3.61 The Government believes Professor Kay's assessment of what constitutes good practice in directors' remuneration is sensible: companies should, to the extent that they vary remuneration according to performance, ensure that they reward the creation of sustainable long-term value in the business and activities which contribute to this goal.

3.62 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.

3.63 Professor Kay's stated intention is that the implementation of long-term incentives for company directors, which are genuinely linked to long-term business performance, should be achieved by promoting good practice by companies. Recommendation 15 is therefore reflected in the Kay Good Practice Statement for Company Directors.

3.64 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. The reforms will empower shareholders to engage effectively with companies, both by introducing a binding vote on pay policy and by increasing transparency through improvements to remuneration reports. This means that what people are paid can be easily understood and the link between pay and performance is clearly drawn, and through binding votes shareholders will be better able to influence and promote change in pay structures.

3.65 These issues are already being debated and the Government is pleased to see that a number of major institutional investors have set out clearly that they expect companies' remuneration policies to be much simpler and include incentive plans which are genuinely long-term in nature.[15] Investors are working with companies to promote this message and the Government welcomes signs of an encouraging response from companies, who are themselves thinking about what good practice looks like.

3.66 The Government will continue to encourage debate about how best to align directors' pay with long-term performance, including by promoting consideration of the Kay Good

[15] See for example Hermes Equity Ownership Services *Discussion Paper: Proposed Reforms to UK Executive Remuneration*, available at: http://www.hermes.co.uk/Portals/8/Pay_discussion_document_2012.pdf

Practice Statement for Company Directors and of other good practice guidance produced by investors and companies.

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.

3.67 The Government supports Professor Kay's view that asset managers' remuneration should be aligned with the interests and timescales of their clients: that is they should be appropriately related to the long-term performance of the fund. Professor Kay's suggested approach – asset managers' having long-term holdings in the fund for which they are responsible – provides a clear model for achieving this.

3.68 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.

3.69 The Government notes that recent developments at EU level will also introduce wider regulation of the remuneration of asset managers.

Recommendation 17:

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

3.70 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[16] and securities law[17] 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.

[16] Central Securities Depositories Legislative Proposal, European Commission website: http://ec.europa.eu/internal_market/financial-markets/central_securities_depositories_en.htm

[17] Harmonisation of Securities Law, European Commission website: http://ec.europa.eu/internal_market/financial-markets/securities-law/index_en.htm

Annex A: 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.
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 includes a focus 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.
11. consult their major long-term investors over major board appointments. (Recommendation 5 of the Kay Report)
12. seek to disengage from the process of managing short-term earnings expectations and announcements. (Recommendation 6 of the Kay Report)

Annex B: 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 (including relevant environmental, social and governance issues), 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.

Annex C: 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.

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