THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING

Interim Report

FEBRUARY 2012

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Foreword

Equity markets are a principal means by which savers can contribute to, and share in, the success of British business. Many people who know nothing of the stock exchange participate in equity markets through their pension funds and other vehicles of long term investment.

Most of the respondents to our consultation – including many from within the financial services sector – felt that these fundamental objectives of rewarding savers through the activities of high performing companies could be more effectively achieved. While the growth of financial intermediation has many positive aspects, intermediation is not an end in itself, and the rewards of intermediation can ultimately be justified only by the contribution such activity makes to economic activity outside the financial sector. Markets exist to serve customers.

The proposals for reform we have received bear on many different areas of policy – such as the governance of companies, the ways in which economic activities are measured, the functioning of markets and the structure of the savings market. This Interim Report summarises the representations that have been made to us, and draws from these representations the issues that will be considered in the second phase of this Review.

John Kay

1. Introduction

1.1. This Interim Report is based on the submissions received, and the many discussions the team has had with market participants in the light of research undertaken by the Review team. The comments reported here reflect the content of those submissions and discussions. They describe the philosophy of the Review, but do not represent even provisional conclusions, and are not recommendations. They are put forward to permit a wider public discussion of the issues which the Review will be considering in its further deliberations.

1.2. The issues with which the Review is concerned are relatively narrow – several respondents have suggested that the scope is too narrow and that the Review should be concerned with the entire spectrum of business finance in the UK. But the range of matters covered by this Review is nevertheless wide. UK law on financial regulation is substantially affected by EU legislation, and it is likely that many of the changes we seek will require changes in that legislation or its implementation. Many – in fact most – important functions in the governance of equity markets are administered by public or quasi-public agencies or in some cases by wholly private bodies. For the purposes of this Interim Report, we have not given specific attention to who would be called upon to act if the ideas put forward to us were to be implemented.

1.3. Where readers of this Report have further evidence relevant to the subjects discussed, we would encourage them to send it to the Review Secretariat for consideration before **27th April 2012**. We respectfully request that these submissions be restricted to evidence not previously submitted as part of the previous call for evidence. A list of respondents to the call for evidence is at Annex A and contact details for the Review Secretariat may be found at Annex C.

1.4. The Final Report of this Review will make recommendations to the Secretary to State, but we anticipate that some of these recommendations will take the form of recommendations that would need to be considered by the bodies with appropriate legal competences, in order for them to be taken forward. Tax is a matter for HM Treasury, and as such the Review will pass any evidence received in this area to HM Treasury who will consider it appropriately.

2. Background

2.1. The purposes of equity markets are to generate returns for savers and to improve the performance of companies. In the long run, returns to savers will be equal to the returns earned by companies, less the costs of intermediation. There is a fundamental alignment between the success of companies and the returns to savers.

2.2. For savers, equity markets are a means by which they can allocate funds between different commercial activities in ways which enable them to benefit from the profits and cash flows generated by these activities. By choosing equity investment, they accept risks associated with uncertainties in the overall economic environment and the performance of individual companies within that environment. Equity markets work effectively for savers when they deliver good returns based on strong business performance and when they operate so as to control, mitigate, and not aggravate, the risks and volatility inseparable from the conduct of business.

2.3. Overall, equity markets are now a relatively minor source of new finance for business investment. Share issues often provide a means by which existing investors can achieve liquidity and – if necessary – exit the market. The principal process of capital allocation for investment in quoted companies is undertaken within the company; the amount and direction of that investment is determined by the managers of the company, and the principal source of funds is the cash flow generated by the corporation itself. The major function of modern equity markets in relation to capital allocation is their oversight of this process. Equity markets work effectively for the corporate sector when they encourage, and do not impede, decision making which enhances the long term competitive capabilities of the business.

2.4. Fifty years ago, most shares were held by individuals, who were advised by stockbrokers with direct knowledge of both their investors and the companies in which they invested. By the 1990s, this structure had been transformed to one in which UK equities were largely owned by (mostly UK) financial institutions, primarily insurance companies and pension funds. Over the last two decades, the proportion of UK shares held by these intermediaries has decreased sharply, and there has been a marked rise in the scale of foreign ownership, a consequence of the globalisation of both corporate activities and equity investment strategies. At the same time, there has been a marked increase in the role of the professional asset manager. The major players in UK equity markets were once individuals and their brokers, who were in time succeeded by insurance companies and pension funds. Today the key agents in the investment chain are professional asset managers.

2.5. Some of these professional asset managers are standalone businesses, others are subsidiaries of financial conglomerates. Some have been created through the outsourcing of investment activities by insurance companies and pension funds,

which have established asset management companies that seek business in the wider marketplace. Some asset managers are based in the UK. An increasing number are not, although many global firms manage their UK or European investments from London. There are many styles of asset management, including traditional ‘long only’ asset management, passive index tracking funds, and hedge funds - a term which itself encompasses a wide range of styles of asset management.

2.6. The concept of share ownership itself bears careful examination. There are at least three relevant aspects of ownership:

- Who makes the decision to buy or sell a particular holding?
- Who decides how the voting rights attached to the shares should be exercised?
- Who enjoys the economic interest in the shares?

There may be different answers to each of these questions, and the registered holder of the shares will often be different still. Reported data on ‘share ownership’ is derived from the share register, with some penetration of the more transparent of nominee holdings. The position is further complicated by the practice of stock lending which usually involves the transfer of title but not economic interest. Whoever enjoys the economic interest in shares, the other two most important rights of ownership – voting and decisions on acquisition and disposal – are most often exercised by asset managers.

2.7. The modern role of asset managers is therefore a key issue for this Review. The critical relationships are those between asset managers and companies, and between asset managers and beneficiaries. The long term public goal for equity markets is in securing the public purposes of high performing companies and strong returns to savers through an effective asset management industry, and in ensuring that the profits earned by companies are as far as possible translated into returns to beneficiaries by minimising the costs of intermediation. Public policy towards equity markets should be judged by its contribution to these goals.

2.8. We heard many references to the merits of liquidity, transparency, price discovery, and other intermediate objectives. While these objectives may be desirable, they are not achieved without cost, and must find their justification in the contribution they make to the fundamental goals of high performing companies and good risk adjusted returns for savers.

2.9. Many respondents to this Review thought that equity markets have lost sight of these goals. For example, the Association of Chartered Certified Accountants (ACCA) observed that “it is sometimes forgotten that equity markets exist not solely to enrich speculators, market makers and intermediaries...It would seem fair to say that equity markets today serve the needs of the players in these markets better than they serve either those who put up the money or the businesses

wanting finance to support growth.” Aviva described “a concern that their (the regulators) practical focus and priority appears to remain targeted at market integrity and efficiency, primarily for (orderly) trading, at the expense of giving primacy to the core role and purpose of the capital markets.” The Association of British Insurers (ABI) similarly observed that “regulation and market practice designed to ensure important but secondary goals may be obstructing the primary purpose.” And the Financial Services Consumer Panel (FSCP) told us that “aggregate capital values have not advanced over the past fifteen years, a period through which, until recently, the economy was growing steadily and when the financial services sector was doing particularly well.”

2.10. Our concern in this Review is with the efficiency of markets in the same sense in which the term efficiency is used in relation to other commercial activities. Is the activity meeting the needs of its customers effectively and at a cost which is commensurate with the value of the services provided? Our view is that every regulatory action must be justified by its contribution to efficiency in that sense. Some semantic confusion is caused by the use of the term ‘market efficiency’ in two other senses. In financial economics, ‘market efficiency’ means the incorporation of available information into market prices. In the language of market participants, ‘market efficiency’ is the smooth functioning of markets, providing traders with liquidity and transparency. From a public interest perspective, however, market efficiency in these narrow senses is of interest only to the extent that it contributes to the broader goal of market efficiency described above.

2.11. Another important semantic issue concerns the multiple senses in which the words long and short are used in financial markets. The basic historical function of equity markets was – and remains – to allow for the different time horizons of companies and savers. Companies could make long term investments, while savers could retain liquidity for their funds because they have the opportunity to realise their investments in the secondary market. Conversely, savers who wished to build up assets could use the equity market to reinvest the returns that companies generated for them, in the same company or in different companies.

2.12. Thus the naive view that because some savers, or those who act on their behalf, have short time horizons the companies in which they invest are obliged to operate to similarly short time horizons is based on a misunderstanding of how equity markets work. The time horizons of companies and savers may interact, but not in this direct way. It is other investors, not the company, who give money back to those who need to realise their investment.

2.13. Another version of the same fallacy sees savers who buy shares in a company as providers of capital to that company. Unless they buy shares in a primary issue, the funds savers provide to the equity market do not go to the company in which they invest: these funds go to a former investor in that company who has sold his shares. Again, there may be an effect on the availability of investment funds to the company, but there is not necessarily such an effect, and it does not arise in this direct way.

2.14. Secondly, the terms long and short may relate to the time horizons of companies – describing the length of the planning period for investment and other major corporate decisions. These words may relate to the time horizons of savers, who may be planning for retirement, or saving towards some more short term goal. They may relate to the time horizons of intermediaries, who may take a short or long term view of the performance targets they agree with their clients, may hold particular investments for a short or long period of time, and who may take a long or short term view of the issues confronting the companies in which they hold shares.

2.15. Finally, the words long and short are used to distinguish market participants with a long interest who hold shares, or have an economic interest in the shares, of a company – and therefore benefit if the company performs well – from market participants who are short sellers who benefit if the company performs badly. Short sellers sell shares they may not own, or engage in an economically equivalent transaction. This may be done in the belief that the share price will fall, although short selling may also be used by asset managers engaged in risk mitigation. In this Interim Report, and in the Final Report, we will attempt to distinguish all these senses of the terms long and short. In line with the overall perspective of the Review, however, our concerns are with companies and savers. The performance of equity markets should therefore be assessed by their effectiveness in allowing companies to make long term decisions appropriate to their business and in allowing savers to make financial plans appropriate to their objectives.

2.16. Many of the responses emphasised the desirability of shareholder engagement with companies as a means to these ends. Many of the proposals made to us were designed to encourage such engagement. Our perspective emphasises decision making by companies which enhances the competitive strengths of their businesses. We recognise it is not always the case that shareholder engagement has the result of encouraging such a perspective. Indeed we received many reports of how shareholder engagement had encouraged companies to engage in financial engineering, to run their businesses to 'make the numbers', or otherwise to emphasise short term financial goals at the expense of the development of the business capabilities. One experienced chief executive told us that "'engagement' was too often for the purpose of forming a view on the direction and prospects of a company rather than contributing positively to these prospects". The Institute of Directors observed that "quoted companies can be subject to short termist pressure from equity markets. This may arise due to fluctuation in share prices or as a result of pressure from sell-side analysts or activist investors (e.g. hedge funds)...short termism in equity markets is likely to have its roots in the short-term investment horizon of many institutional shareholders. The investment strategy of a significant proportion of fund managers is oriented towards share trading rather than long-term company ownership."

2.17. There was wide agreement among respondents to the Review on the shape of an asset management industry which would best achieve the goals of high performing companies and strong returns to beneficiaries. The concept of

stewardship is central. Asset managers are stewards of the funds entrusted to them by investors. They discharge that function most effectively by acting as stewards of the corporate assets they control by virtue of their management of these funds. Such stewardship is the only means by which, taken as a whole, the financial services sector can discharge its responsibilities to those who entrust funds to it.

2.18. There was not unanimity on this issue. Some respondents believed that the current relationship between asset managers and companies worked well in aligning the interests of companies in improving their performance and the interests of savers in good and secure long term returns. They took the view that those who favoured stewardship wanted to substitute the opinion of asset managers for the judgment of 'the market', and thought such substitution was undesirable. But such anthropomorphisation of 'the market' involves a misunderstanding. The judgment of 'the market' is, simply the aggregated opinion of asset managers and others who make investment decisions.

2.19. The relevant distinction is in the way the opinions of asset managers are expressed. A fruitful way of describing the issue uses Hirschman's famous distinction between 'exit' and 'voice' as means of expressing dissatisfaction in a market economy. Stewardship emphasises voice over exit. Those who favoured exit pointed out that shareholders could effectively influence management by selling their shares, and that this mechanism, rather than the formal process of meetings with companies, provided a powerful means of expressing opinions on corporate performance. Others doubted the effectiveness of exit, believing that managers could ignore a weak share price until the point at which it left the company vulnerable to hostile takeover, or that the scope for exit was limited by the problems fund managers faced in departing too far from an indexed benchmark, or from adopting investment approaches that were significantly different from their peers.

2.20. Stewardship extends more widely than the set of issues commonly discussed as corporate governance. Asset managers concerned with stewardship would be expected to engage with, and be committed to, the companies in which they held stock. They would normally be supportive of company management, but would be ready to engage in constructive criticism and, in the extreme cases, to act themselves or in conjunction with others to effect change.

2.21. Most of our respondents believed that there was too little stewardship of this kind. Sir Terry Leahy, perhaps Britain's most successful and respected manager of the last two decades, told us that he did not feel he had enjoyed such a relationship with analysts and fund managers during his time as chief executive of Tesco, and that he had missed the opportunity for such engagement. He further told us that he felt that the interaction had deteriorated rather than improved: that analysts and fund managers had become more concerned with quarterly numbers and with earnings guidance, and less with the strategic direction of the business.

2.22. Neil Woodford, a notably successful fund manager who has developed a stewardship relationship with many investee companies, described to us the obstacles to the pursuit of this goal. He listed the following factors:

- The measurement of fund management performance over short time scales
- The broader industry's obsession with quarterly reporting
- Corporate management's interactions with intermediaries (investment bankers and sell-side analysts) at the expense of interaction with 'owners'
- The remuneration structures of fund management professionals – an over emphasis on one year returns rather than longer time periods
- Fund management fashions – for example, the popularity, for obvious reasons, of hedge fund management techniques
- Human nature – the innate preference for conventional failure over unconventional success
- Regulation, in particular of pension funds, has helped to significantly diminish the role equity investment can play in providing attractive long-term returns to savers
- Incentive structures in the broking industry which encourage increased trading activity
- Technology
    - The increasing prevalence of high frequency trading strategies
    - The ability to remain constantly in touch with market movements for example via mobile devices
    - The fall in equity dealing costs
    - The proliferation of derivative strategies which drive underlying cash market turnover
- The absence of fiscal incentives that might favour long-term investment strategies
- The tyranny of the benchmark has created an environment where fund managers are less inclined to back businesses or industries for the long-term because they are concerned with the career risk of moving too far away from their benchmark index over shorter time periods.

We discuss these issues further in the course of this Report.

2.23. The stewardship we describe is certainly not the only style of asset management, and we do not suggest that it should be pursued to the exclusion of other approaches. But the broad objectives of stewardship won wide support. If there was disagreement in the submissions we received, it was mainly over the degree to which this structure has in fact already been achieved, and the most appropriate measures to effect further change in that direction. The further work of the Review will therefore be largely concerned with these issues.

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3. The company and the board

3.1. The Companies Act 2006 codified the duties of directors. For the purposes of this Review, the critical section is s172(1).

Duty to promote the success of the company(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –

(a) the likely consequences of any decision in the long term,

(b) the interests of the company's employees,

(c) the need to foster the company's business relationships with suppliers, customers and others,

(d) the impact of the company's operations on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.

The definition provided in s172(1), often described as 'enlightened shareholder value', requires directors to have regard to the long term interests of the company. The majority of respondents took the view that this definition gave sufficient emphasis to the success of the company and the promotion of its long term performance.

3.2. The ACCA drew attention to a study undertaken on its behalf by Professor Collison. He reported that the corporate executives in his study seemed to interpret the law as imposing a requirement to maximise the share price in the short term. It seems unlikely that Professor Collison's respondents did not know what the law was: these responses may therefore illustrate their state of mind rather than their understanding of the law. The TUC commented that "what directors' duties require of directors in reality is almost irrelevant if this [i.e. a narrow interpretation of enlightened shareholder value of the kind encountered by Professor Collison] is how directors interpret their duties", and went on to suggest that s172 should be reformulated so that the directors were required to promote the long-term success of the company.

3.3. The legal position is appropriately framed in general terms. It is desirable to ensure that the honest exercise of business judgment is not subject to legal challenge. But one consequence of such generality is that legislation may be open

to personal interpretation which is not strongly supported by the terms of the law: another consequence is that legal advice may tend towards narrow risk-averse interpretations designed to protect the client, and the adviser, against possible challenge. This problem of risk-averse legal advice arises in other contexts in our Review.

3.4. The specification of directors' duties has particular significance in the context of takeovers. Several respondents pointed to the issues that arise when the directors of a company believe that the prospective acquirer will not be a good owner of the company:

- Are the directors free to recommend rejection of the highest bid, or a bid which significantly exceeds the current share price?

- Does it matter if they do so anyway, since such a bid is likely to be accepted by shareholders?

3.5. Sir Roger Carr, describing his experience as chairman of Cadbury during the takeover bid from Kraft, told us that the board did not believe it was possible to reject a high bid that reflected full value for the business even if they considered that the long term success of the company may best be achieved if it remained independent.

3.6. Several respondents suggested that while it was once the case that shareholding was dominated by large UK institutions which were likely to have long term stakes in both the acquirer and the company potentially to be acquired, and could therefore take a view of the merits of the transaction as a whole, this was no longer true. In some recent transactions a large proportion of shares in the target company had been owned by arbitrageurs whose only interest was in a rapid, profitable exit.

3.7. There was wide agreement that the ability to mount a successful takeover now depends almost solely on the capacity and inclination to offer sufficient premium to the likely share price in the absence of the bid. We were told that Britain is an extreme case, among developed economies, in its openness to hostile takeover. Some respondents felt that this freedom simply represented the effective operation of a market for corporate control. Others took the view that there should be greater opportunity for directors to take a longer term view of the prospects of the company in line with the provisions of s172.

3.8. The Takeover Panel has extensive responsibilities in the supervision of bids in the UK. However as the Panel told us that "The financial and commercial merits of takeovers are not the responsibility of the Panel. These are matters for the companies concerned and their shareholders. In addition, it is not the purpose of the Code either to facilitate or to impede takeovers. Nor is the Panel responsible for competition policy or wider questions of public interest, which are the responsibility of government and other bodies." It is, however, precisely this wider

question of public interest – the long term success of British companies – which is the concern of this Review.

3.9. If greater opportunity for rejection of bids which do not promote the long term success of either company – acquirer or acquiree – were desirable, there are several, not necessarily mutually exclusive, means by which this could be achieved:

- More discretion for directors to reject unsuitable bids (but this might lead, as in the US, to managers protecting their own interests at the expense of shareholders and other stakeholders)
- The possibility of review of takeovers by a public agency (a route at present generally only available where competition issues arise)
- Differential rights for shareholders
- Lowering (for the bidder) or raising (for the target) the threshold at which shareholder approval of a bid is required.

3.10. A number of respondents have proposed that long term shareholders should receive enhanced voting rights. UK company law does not currently restrict this, but it would represent a significant change in custom and practice. One proposal would relate specifically to takeovers, and disqualify voting by shareholders who had acquired shares after announcement of the bid. Arbitrageurs would therefore have a reduced influence on the outcome of the bid process. The principle of a qualifying period before voting rights are acquired might be applied generally, and not just in the context of a takeover. Some respondents favoured a process through which shareholders might acquire enhanced voting rights after holding their shares for a period of years, suggesting that this could be mandated by legislation, or implemented by individual companies through their articles of association. However, it should be noted that in 2010 The Takeover Panel dismissed the idea of disenfranchising the owners of shares acquired during offer periods, in the light of public responses.

3.11. In Britain, differential rights between shareholders were often used to maintain family control of a company after the founders had relinquished the dominant economic interest in the business. These structures were viewed with considerable hostility by large institutional shareholders. As a result, they are now rare, although there are still some well publicised examples of companies where differential share classes are still found.

3.12. But the corporate landscape in Britain today has changed. Direct share ownership by individuals is much less common. The UK Listing Authority has seen maintaining liquidity through a significant ‘free float’ as a principal objective. Asset managers dominate. There are few large companies in which any single shareholder or identifiable group of shareholders has a substantial stake, and this

limits both the ability of the company to enjoy a strong relationship with any shareholder and the capacity of any shareholder to influence the company.

3.13. The concept that all ordinary shareholders should have the same rights is now established as good market practice in the UK. However, this principle is based on convention rather than law and, as noted, some companies do have share structures which confer different rights on different groups of shareholders. The principle of equal treatment of shareholders of the same class, in the particular circumstances of a bid, is the first principle of the Takeover Panel's City Code.

3.14. While only a few respondents were willing to challenge the concept of equal treatment of all ordinary shareholders directly, many implicitly did so, suggesting ways in which advantages might be conferred on committed and long term shareholders – through tax reliefs, enhanced voting rights, or other benefits from contact with companies. Many of these measures could be implemented by companies themselves, who do have considerable flexibility under existing law and regulation. But such a change would probably need to postdate a review of market practice by investors or their representatives.

3.15. If shareholders were not treated equally, then some shareholders who did not receive the advantages given to others might be discouraged from entering the market. It is not obvious that such discouragement would always be a bad outcome; there are good and bad forms of shareholder engagement, and therefore good and bad shareholders and good and bad styles of trading and investing. The overall effect would depend on the identity and behaviour of the shareholders were so disadvantaged, and the consequences of their possible exclusion for the company and the returns to the beneficiaries of equity ownership. There might be particular concern if the category of the disadvantaged included small individual shareholders, but the representatives of private clients who made submissions to us emphasised that their customers tended to be long term holders of shares. Measures to favour some shareholders might plausibly be to the benefit of shareholders as a whole if it facilitated better governance and decision making within companies.

3.16. Some respondents favoured the establishment of a shareholder committee. There were several different versions of this proposal. Some advocated such a committee to amplify the voice of small individual shareholders – but, as we have noted, even in aggregate individual shareholders now represent only a proportion of the beneficial ownership of listed companies. Another proposal suggested using the device of the shareholder committee to give a collective voice to the largest asset managers and those major investment institutions which held shares directly.

3.17. Large shareholders are, of course, free to establish a shareholder committee for themselves at any time. However, it was suggested that explicit provision for such an arrangement would encourage the participation of committed shareholders, and naturally provide a forum for the collective discussion of matters – such as executive remuneration – which may cause general concern to shareholders.

Several respondents observed that it was appropriate that the rights attached to the ownership of shares should also carry obligations.

3.18. The ABI and the National Association of Pension Funds (NAPF) once played a more active role in coordinating shareholder opinions than they do today. Collective action was typically concerned with two types of issue: the resolution of governance problems in individual companies, and the formulation of policies on broad issues such as pre-emption rights and non-voting shares. It is primarily the first group of questions with which this Review is concerned, and to which a shareholder committee might be relevant.

3.19. The principal reason for the decline in organised collective action is probably that the ABI and NAPF now represent a lower proportion of all shareholders. There may also be a stronger sense that members are in competition with each other. Several respondents commented that the increased foreign ownership of UK equities had influenced the nature of, and opportunities for, collective action by shareholders. Not only had the shareholding base become more heterogeneous, with shareholders less likely to know each other well, but foreign – particularly US – firms tended to be more aggressively competitive in their approach and may be familiar with different and more restrictive rules on the definition of concert party.

3.20. The Institutional Investor Committee – a joint group comprising the ABI, Investment Management Association (IMA) and the NAPF – might provide a basis for enhanced collective action, although its principal current role is as a forum for industry representation on matters of policy and regulation.

3.21. Some respondents expressed concern about the selection of non-executives, suggesting that the method by which they are appointed – typically, by a committee of the board with substantial input from the Chairman – often led to a board composition which offered insufficient challenge to executive management. There were also suggestions that there was not enough diversity in non-executive appointment Lord Davies has separately reviewed the appointment of women to company boards, but our respondents were concerned principally with broader issues of diversity of backgrounds, and that some non-executive directors may hold too many non-executive roles to be able to perform effectively. Cevian Capital drew attention to a Swedish system, in which a shareholder committee at the company level participates in the selection of non-executive directors.

3.22. Many respondents took the view that existing practice, and the recently introduced Stewardship Code, emphasised the formalities rather than the substance of board appointment and decision-making. It was suggested to us that these rules were sometimes counter-productive. Knowledge and understanding come from experience with a company: but that experience is seen, with some reason, as jeopardising independence. This trade-off is recognised in the rules for rotation of auditors and non-executive directors. Strikingly the normal limits of appointment here - six and nine years respectively – are significantly higher than the typical holding period for shares. Previous association with the company – as auditor or adviser – counts against the independence of a non-executive director, but

individuals with such knowledge give the company an opportunity to obtain a knowledgeable, critical voice. More fundamentally, the concept of stewardship implied a group of people committed to the long term success of the company, rather than a rotating panel of temporary appointees. Perhaps there is no set of rules that can define the composition of an effective board.

3.23. Companies cannot engage with shareholders or beneficial owners unless they know who they are. Under s793 of the Companies Act 2006 public companies have the right to ask for information about the beneficial ownership of their shares. The 100 Group, and others, drew attention to difficulties in getting prompt replies. The right to seek information may become ineffective when the shareholders are located outside the UK.

3.24. Whilst the growth in foreign ownership of UK securities gives added dimension to the issue of identifying beneficial owners, we should emphasise that the concerns that have been raised are not in any sense aimed at foreigners. Some non-UK based asset managers and shareholders conduct their business in a manner which is a model for the kind of constructive engagement we seek more generally. A further issue is that the complexity of equity markets, especially the use of derivative securities, means that the economic interest in the shares will often be enjoyed by someone other than the registered holder (or the person the registered holder represents).

3.25. Although other respondents drew attention to these problems, we received no specific suggestions for actions that might be taken to remedy them. One general question is whether people or bodies who have an economic interest in a business, but who cannot be constructively involved with the management of that business by virtue of anonymity, remoteness or the nature of their interest should expect to enjoy similar rights vis-à-vis that business as others who are engaged shareholders in the business.

3.26. In terms of other drivers for long term holding of UK equities, Capital Gains Tax has some incentive to long term holding of shares built into its structure, since it is payable only on realisation (and eliminated on death). From 1998-2008 this incentive was increased by taper relief, which reduced the proportion of the gain subject to tax by reference to the length of time the asset had been held. Before 1998, indexation relief had a somewhat similar effect. In 2008, taper relief was abolished, and a single, lower rate was imposed on capital gains of all kinds.

3.27. We received no evidence on the effects of either the introduction of taper relief or its abolition, although the frequency of changes to the UK capital gains tax regime would seem to provide fertile ground for research into the impact of the tax. Nevertheless, several respondents felt that taper relief, or similar tax advantages for long term holders, should be reintroduced.

3.28. Capital Gains Tax is relevant only for a minority of shareholders in UK companies. Its principal effect is on UK resident individuals who directly own shares. UK resident individuals who hold collective funds are liable to tax on their investment

in the fund, which is itself exempt from tax on capital gains, so that the behaviour of these holders affects long term decision making only indirectly through the influence it may have on their willingness to hold funds long term.

3.29. Many individuals who hold shares directly do so though ISAs or SIPPs to which capital gains tax does not apply, and the significant proportion of shareholding individuals who are directors or employees will be motivated mainly by different considerations in their shareholding decisions. Individuals do not make a large contribution to the scale of short term trading. Taken as a whole, these factors may suggest that the tax incentives for private individuals to hold shares at all may be more relevant to this Review than the incentives to hold them for particular lengths of time.

3.30. ISAs are the provide principal fiscal incentive for UK taxpayers to invest in equities. UK residents can save an overall limit of £10,680 (2011/12) each year in a tax free vehicle. Up to £5,340 can be put into a cash ISA, however the whole amount may be invested in stocks and shares. The latter concession applies to securities quoted on a recognised stock exchange, so that it is possible (in principle) and in practice increasingly easy to buy shares listed on regulated stock exchanges based outside the UK. AIM stocks, however, cannot be held in an ISA. The tax concessions on UK equities are worth little to basic rate taxpayers who gain no income tax advantage and will mostly not pay capital gains tax in any event.

3.31. Since the introduction of electronic trading and settlement on the London Stock Exchange in the mid 1990s, nominee holdings have accounted for a growing proportion – probably now the majority – of personal shareholdings of UK equities. The practice of holding through nominees means that the beneficial owners are not on the share register, do not receive information directly from the company, and do not have voting rights. The Companies Act 2006 contained provisions to strengthen the position of beneficial owners in these respects, but it was reported to us that this has had little effect in practice.

3.32. Personal shareholders can establish a direct link with companies by holding their shares in certificated form, but shares held in this form can be costly to trade. Personal shareholders can also become personal members of CREST, the trading and settlement system. However, such membership requires sponsorship by a broker, and only a few stockbrokers – principally large independent private client brokers – offer this service to their clients. HMRC rules require that shares held in an ISA are held through a nominee account.

3.33. Several respondents drew attention to the consequent disenfranchisement of personal shareholders. They pointed out that personal shareholders have significantly longer than average holding periods for their shares, and that many of them have a real interest in the long term stability and growth of the companies in which they invest. The wide use of nominee accounts may have been necessary to reap the efficiency savings from electronic trading and settlement at a time when most private individuals did not have access to the required information

technology. However that is no longer true. One option is that personal CREST membership might be the normal means by which UK private individuals hold UK equities.

3.34. Many submissions raised the subject of executive remuneration. This is the subject of a separate BIS inquiry, and we will consider it in this Review only insofar as it relates directly to the subject of our enquiry – equity markets and long term decision making. Our principal concern is therefore with the design, rather than the quantum, of executive remuneration.

3.35. The principal stated rationale for the changes in the structure of executive pay in the UK over the last three decades has been a desire to align the incentives of managers with the interests of shareholders. It does not appear that this objective has been successfully achieved. Indeed the conversations which the Review team has had with those who represent the interests of shareholders suggests that the design of executive remuneration schemes, far from being an issue which brings managers and shareholders closer together, is now a principal source of friction between them.

3.36. The Co-operative Asset Management told us that “what started as an intention to minimise agency costs by internalising the principle of shareholder value has ended up more like a short term call option on shareholders’ assets”. The robustness of their tone was something we encountered in numerous discussions. ShareSoc’s poll of its members – personal shareholders – found that 83% agreed or strongly agreed with the statement “too much emphasis is placed on performance related pay elements”.

3.37. Executive remuneration schemes have steadily increased in complexity. We were shown data which indicated that returns from long term incentive plans were now normally the largest component. The most common time horizon for these ‘long term’ plans is three years. In our discussions, many people suggested that this was far shorter than the timescale over which the consequences of major corporate decisions would emerge.

3.38. This problem was particularly clear for banks. The IMA reported that “accounting requirements...allowed changes in the fair value of assets to be taken to earnings even when the holdings concerned were so large that they could not have been realised at those values. These unrealised gains were used as a basis for performance related remuneration of both boards and bankers even though these gains never resulted in cash flows. This disconnect between earnings and value creation had to be subsequently reversed when the assumptions proved to be erroneous.” The issue of metrics is discussed further in Chapter 4 below.

3.39. Respondents also expressed concern that the design of schemes was effectively asymmetric – that managers benefited more from the upside than they suffered from the downside. This has led to widespread criticism of ‘rewards for failure’. But also – and central to the Review’s concerns – such asymmetry encourages decisions, such as major acquisitions, which are likely to have large effects for

good or ill in a relatively short time scale. Paradoxically, the effect of a 'long term incentive plan' may be to encourage risk taking with a short time horizon. Several respondents observed that the incentive which most closely aligned the interests of managers and the interests of shareholders was management holding of shares. Since the time scales on which the effect of important decisions on the performance of companies was frequently longer than the average tenure of a chief executive, such shares should be held up to or beyond the date at which the executive leaves office.

3.40. Since the Cadbury Report of 1992, 'comply or explain' has been a basic principle in the corporate governance of listed companies. Those respondents who commented on this principle – whether from the corporate sector, asset managers, or representatives of savers – took the view that it generally operated satisfactorily. They considered the outcome had been a high degree of compliance with the recommendations of the Cadbury and subsequent codes, but that the system had left companies with flexibility to deal with particular circumstances – or in particular cases the ability to operate in line with the idiosyncratic views of some boards of directors.

3.41. The European Commission has expressed concern about the 'comply or explain' principle, mainly on the grounds that explanation, when given, is sometimes thin. We note the Financial Reporting Council issued a report on what constitutes an 'explanation'.

3.42. 'Comply or explain' is a mandatory requirement. There is a broader issue of when it is necessary to regulate through specific prescriptive rules and when looser principles based approaches are more appropriate, and when statements of good practice, adherence to which may confer a degree of protection against legal or regulatory action, should be used. The sense of our respondents was that there were roles for each, but we were offered little specific guidance as to the criteria to be applied in the choice.

3.43. The emphasis in this Review is on the outcome rather than the process of regulation. If the results are generally satisfactory, we will normally take the view that the means of achieving these results are satisfactory.

4. Measurement and reporting

4.1. Information is the lifeblood of securities markets. One of the principal functions of these markets is to act as a conduit for processing information. Much trade results from differences in the information which is held or differences in the ways in which the same information is interpreted. When policy problems are identified in markets or by the users of markets the most common political and regulatory response is to advocate more disclosure or greater transparency.

4.2. There is a technical argument over the degree of transparency which contributes most to the efficiency of trading, an argument which has gained salience as a result of the creation of so-called ‘dark pools’ of liquidity. But the general principle that more information is better has driven regulation of both corporate governance and securities markets in the past, and continues to do so. Many submissions praised the virtues of transparency and disclosure in general terms. When the concepts are abstract principles, it is hard to disagree with the merits of transparency and disclosure.

4.3. And yet it would be difficult to read the responses to the Review’s consultation without acquiring some scepticism as to whether the beliefs that more information is always better, that greater transparency is desirable, that more disclosure is beneficial, are always well founded. We were told frequently of problems in the dissemination and sharing of information, we were told that information was useless or misleading and we were told that agents acted, or felt under pressure or obligation to act, on information even though they did not believe that doing so was in the best interests of those they represent.

4.4. There is wide consensus among respondents to the Review that quarterly reporting and the preparation of interim management statements have adverse effects on the behaviour of companies and investors. This consensus is reflected in recent proposals from the European Commission on the review of the Transparency Directive where this reporting obligation is currently being considered. As our respondents see it, the problem is not simply that the production of useless information entails costs: the preparation and dissemination of useless information distracts attention from matters of more central importance: ‘too much data, not enough information’.

4.5. This observation has wide implications. Financial markets exist, in large part, because information is imperfect and subject to conflicting interpretation. A common reaction has been to demand more information. After all, information which is not of use need not be used. But this response ignores the considerable evidence from experimental psychology – and everyday life – that it is easy to induce people to act on irrelevant information. The Review will be concerned with the quality as well as the range and quantity of information. Less may mean more, and more may mean less.

4.6. We gained a sense of overload in both the provision and receipt of information. The Asset Managers and Investors Council (AMIC) expressed the issue with a tone of resignation. “Publicly traded companies are subject to a constant flow of information. And although the AMIC feels they do pay too much attention to short term fluctuations in their share price, we believe that this is due to the nature of the environment they are in. They are forced to consider the press and investors’ concern on a permanent basis”. This overload has added to the overall cost of intermediation. But the underlying point was a more subtle one. It was that information was often not wrong, not even necessarily misleading as a description of what it represented, but inappropriate for the purpose for which it was used: and that bad information, in this sense, led to bad decisions. Versions of this point were made by actors throughout the investment chain, from company directors to trustees.

4.7. For example, Standard Life Investors told us that “the noise – positive or negative – arising in response to quarterly interim management statements is an unwelcome distraction in the context of encouraging boards to focus on the long term development of the business”.

4.8. Many respondents raised the impact of the adoption of mark to market accounting in corporate accounts of the liabilities of UK pension funds. They believed that the result of these provisions had been an acceleration of the closure of defined benefit pension schemes and a substantial reduction in the commitment of UK pension funds to both UK and overseas equities. They suggested that this outcome had not been intended. Respondents also implied, and some explicitly stated, that the result benefitted no one: not pensioners, not the interests of companies which made pension provision, nor the UK economy.

4.9. Pension fund accounting valuations are sensitive to short term fluctuations in securities prices and interest rates. Changes in bond yields may have large effects on the valuation of assets and liabilities even if the anticipated cash flows remain the same. Such fluctuations may have an impact on the financial reporting of the company which could be unrelated to the underlying competitive performance of the business. A result is the conflation in company reporting of short term market fluctuations outside the control of the business and the impact of measures relevant to long term business performance. The previous arrangement can equally be attacked as using measures which need have borne no relation to the present or future valuation of the assets. Respondents said their companies had reacted to the unwanted volatility by reducing their holdings of equities, UK and foreign, in the portfolios of their schemes. Concern about the effect on balance sheets had made management focus on the risks that pension commitments posed to the company, and has been a factor in accelerating the closure of defined benefit schemes. Since UK pension funds are committed long term holders of UK equities, these reductions in holdings had reduced both the quality and quantity of investment in the UK equity markets. This change, it was suggested, was neither intended nor desirable.

4.10. The unintended and undesired consequences of more extensive regulation of pension funds are representative of an issue which we encountered in almost every aspect of the regulation of financial services as it bears on equity markets. In contrast to regulatory approaches in many other sectors of economic activity, regulation of financial services emphasises process over outcome, and is directed to the operation of the market itself rather than the results of market activity. Many respondents expressed this concern. The ABI told us that "the regulation of equity markets is increasingly concerned with trading in the secondary markets." The Local Authority Pension Funds Forum noted that "the general direction of policy has been to encourage the trading part of the market, with a tendency to regulate away direct bilateral contact". A large activist fund manager, Hermes, summed up the issue in this way; "our belief is that the regulatory framework for the markets and the structure of those markets has increasingly moved to favour liquidity and trading activity over long term ownership".

4.11. The widespread criticism of the consequences of mark to market accounting is also illustrative of a larger issue. A company's accounts are a snapshot on a particular day. They must present a true and fair view of the affairs of the company and also contain information about the past, present and future. Not only will elements always be volatile, but subjectivity is also inevitable. It is not realistic to imagine that any prescribed body of quantitative data can fully meet all these purposes. It requires skill, judgment and experience to interpret such information, which to be adequately understood will always need to be supplemented by specific knowledge of company and industry.

4.12. Companies are required to mark to market assets and liabilities which they may have no intention of realising – such as the net liability to the pension fund – and which in many cases could not be realised without wide-ranging implications for the business itself. Some respondents felt that information of this kind was useless or misleading.

4.13. But even if directors, shareholders and investment intermediaries attempt to disregard information they perceive as having little or no value, they may be unable to do so. There may be a good case for providing the information contained in an actuarial estimate of a pension fund deficit, but the decision as to what action to take on that information is not just a matter for the trustees and the actuary, but for the Pensions Regulator. The Pensions Act 2004 requires that corporate sponsors have plans for the elimination of deficits. This means that the information contained in regular mark to market assessments is material whether or not the company believes it is relevant. More generally, there are many participants in equity markets. Even if those who generate information doubt its value, their assessment will not necessarily be shared by others.

4.14. A large majority of respondents, whether they represented companies or investors, considered that quarterly reporting and interim management statements fell into the category of useless or misleading information. They took the view that this frequency of reporting was excessive for many businesses. Aside from the burden such reporting imposed in itself, quarterly reporting had led to an unhealthy

focus on ‘making the numbers’ at the expense of the long term growth and development of the business.

4.15. One very experienced chief executive told us “the pressures of frequent reporting encourage an emphasis on short term actions. It is much more exciting to be able to report quick wins instead of the slow-moving and un-newsworthy progress to a long term goal”.

4.16. Some respondents also noted that where mandatory or conventional reporting requirements were relaxed, companies were inclined to give more attention to communicating specific information which was relevant to the specific circumstances of their business. The CBI urged that reporting “should be driven by shareholder need rather than broad-brush regulation”.

4.17. Reporting obligations for insurance companies were an issue of particular concern to many respondents. They told us that the evolution of regulation imposing minimum capital requirements for insurance companies, most recently with the development of the Solvency II directive, has contributed to UK insurers reducing their commitment to equities. As with pension fund regulation, this portfolio rebalancing is not necessarily in the long term interest of potential beneficiaries who use insurance as a savings product and has reduced the role in the markets of another group of potentially committed long term holders of UK equities. Many respondents expressed concern about current EU proposals to apply rigid funding requirements similar to those in the Solvency II directive to occupational pension schemes in place of the current, relatively flexible, funding regime and regulatory approach which is based on actuarial assessment and aims to take account of the strength and commitment of the sponsoring employer.

4.18. Both Solvency II and pension fund regulation require the use of actuarial and/or economic models. But models are not confined to these sectors: similar models are used throughout the financial sector. There is regulatory pressure and in some instances regulatory requirement to employ these models, as in the use of value at risk models on the banking sector and the application of similar methods in assessing risk in the insurance sector. In practice, a relatively small number of models are used widely across the financial services industry, although considerable work is undertaken by firms in customising models and in selecting assumptions appropriate to that particular business. Inappropriate reliance on such models by both regulators and regulated firms themselves was an important contributor to the financial crisis of 2007-8.

4.19. We were surprised not to receive submissions on the implications of the wide use of such models, in view of the widespread criticisms which have been levelled since those events. For the purposes of this Review, however, one aspect of those criticisms is of particular significance. Many of the models appear to have intrinsic short-term biases built into their structure, particularly in their treatment of risk and volatility. Portfolio models widely used to design liability driven investment strategies interpret risk as volatility of return over one year. The capital asset

pricing model extensively used to estimate the cost of capital to business bases its assessment of risk commonly derived from monthly stock price volatility.

4.20. The CFA Institute drew particular attention to the widespread use of metrics which were not sufficiently closely related to long term value creation, which they identified as equal to the free cash flow generated by the business in the long run. The Institute was particularly critical of the use of earnings per share (EPS), which takes no account of the capital invested in the business. Measuring corporate performance by return on equity – an indicator particularly emphasised, and still emphasised, in the banking sector – gives artificial incentives to increase gearing and assume risks. Total shareholder return (TSR) gives credit for market beliefs about corporate performance, as distinct from corporate performance itself. One respondent described it as “a lottery for executives”. The CFA Institute provided evidence that EPS and TSR were the performance metrics most commonly used in the calculation of executive remuneration.

4.21. Many respondents, including asset managers and trustees as well as pension funds, called for a wider use of metrics related to environmental, social and governance issues. For example, RPMI Railpen told us that “there is a perception among asset owners and other stakeholders that some analysts concentrate on too narrow [sic] range of numbers and do not take broader risks, including environmental, social and governance (ESG) risks, and other qualitative factors, which may have a longer-term impact, into account”. Railpen went on to hope that the Integrated Reporting Initiative would help address these issues. We would welcome ideas on how this should be developed within the general context of an approach which emphasises user driven information rather than data and prefers engagement to more extensive reporting as a means towards this end.

4.22. Metrics and models are also widely used in asset management. Most funds have, and most mandates provide, benchmarks and managers regularly report their performance in relation to the benchmark. Risk management systems for asset management businesses typically measure risk as tracking error.

4.23. Some respondents suggested that these practices divert attention from the long term performance of companies and the pursuit of returns for savers. One fund manager observed that such measures reflect the business goals of the asset manager rather than the interests of the underlying beneficiaries. We discuss these issues further below.

5. Market practice

5.1. Many respondents were concerned about the state of the initial public offering (IPO) market in the UK. The ABI told us “the primary equity markets in the UK are not functioning well at present”. The number of companies listed on the main exchange in London has fallen by around half over the last decade. New listings declined globally after the financial crisis of 2007 – 2008, but most markets have seen some subsequent recovery: a similar recovery has not occurred in the UK.

5.2. The fall in listings on the main exchange after 2000 has to some extent been compensated by the growth of AIM, the secondary market. However the number of AIM-listed companies peaked in 2007 and has since declined.

5.3. Some large institutions described the present situation as a ‘buyer’s strike’. They told us they had become disenchanted with what they saw as the low quality of new listings offered. Good companies were deterred from seeking main market listings by the high costs of issuance and the increasing regulatory burden and other obligations associated with listing. The quality of advice provided by the nominated advisors (NOMADs) and others to AIM firms was criticised. We were told that when private companies sought an exit for their private equity investors, listing was frequently seen as a last resort, to be undertaken only when other avenues – such as a trade sale, reconstruction, or sale of secondary interest – had been ruled out.

5.4. Many respondents drew attention to the direct and indirect effects of the differential tax treatment of equity and corporate debt. The effects noted by respondents included

- The decline in new equity issuance.
- The incentive such tax discrimination provides to engage in financial engineering.
- Short term pressures generated by excessive leverage.
- The growth of private equity relative to public markets.

However none of the submissions we received considered the issues involved in addressing this differential in any detail.

5.5. Differentiation between the treatment of debt and equity has been integral to the structure of UK corporation tax since its inception. Reform aimed at this issue would therefore necessarily involve a comprehensive review of that structure, which is beyond our scope. But it is not only in the present context that possible adverse effects of the current system have been identified. A series of concerns, none in themselves sufficient to justify a root and branch reform of the tax system,

may in cumulative effect be more than sufficient to do so.The tax advantage of equity over debt might be reduced by restricting the deductibility of debt interest, by increasing the attractiveness of equity financing, or by a combination of the two.

5.6. Reducing or removing interest deductibility would entail extended and complex transitional arrangements. In addition, we note that at the current time the government is committed to interest being relieved as a normal business expense.

5.7. The most widely canvassed proposal for addressing the issue of unwanted discrimination by making equity capital more fiscally attractive is an allowance for corporate equity, which would permit companies to charge against corporation tax a notional interest component related to their use of equity finance. The revenue consequences of such a proposal, in the absence of a wider review of the tax system, would be considerable. In any event, the international complications associated with the structure of Corporation Tax are now so complex and extensive that any change would be best accomplished within a context of international agreement.

5.8. The shortage of new listings by UK based companies has been partly offset by the listing on the wider market of companies, many of them mining or commodity based, whose operations are wholly or substantially outside the UK. Many respondents were critical of this development. They told us that such companies often had standards of corporate governance well below those expected of UK-based companies, as well as a limited free float of shares. They thought it was regrettable that listing requirements had been relaxed.

5.9. Some of those we talked to were sanguine about the listing of these foreign companies. They identified some advantages to the UK economy from the revenues derived by the City of London, and saw few disadvantages: no one is obliged to invest in a company with a limited free float and weak governance. A larger group of respondents, however, expressed concerns. We were told that the effect was to 'lower the tone' of the UK equity market. When critics were pressed as to what this meant, they suggested that the inclusion of some companies of low quality in London market listings reduced the attractiveness of all equity investment: and particularly its appeal to the type of long term committed investor whose role the Review seeks to enhance. Royal London spoke for others when they said "our effort to establish high standards for companies listed within the UK from wherever they come is weakened by the position that is currently adopted by the UK Listing Authority".

5.10. We note that the Financial Services Authority, in its recent consultation paper (CP12/2) on proposed amendments to the Listing Rules, has reflected concerns expressed about free float and governance. In the paper, the FSA explains that the current free float requirements, derived from EU law, are explicitly drawn in relation to liquidity, rather than governance, issues, and that because of this it is not possible to use these requirements to decide whether any specific issuer is suitable for listing or not. In addition, in relation to concerns over governance it should be noted that premium listed companies also have to 'comply or explain'

against the UK Corporate Governance Code. The FSA consultation paper also invites the views of market participants on the wider question of whether the premium listing standard, as set out in the Listing Rules, remains correctly positioned as a benchmark of high standards and whether there are any specific enhancements to the Listing Rules that may be desirable in providing additional protections for investors, and particularly for minority shareholders.

5.11. We were reminded that some shareholders choose to require themselves to invest in such companies. When companies are included in UK market indices, index tracking funds must hold them, whatever view their corporate governance specialists may take. Most actively managed funds have index benchmarks, and must therefore think carefully before adopting seriously underweight positions in index components.

5.12. Managers are subject to risk assessment procedures which are based on index benchmarks. These record underweight positions in companies of which the fund manager has a low opinion as adding to, rather than subtracting from, the overall riskiness of a portfolio. Some of the problems described here might be dealt with by better understanding of the varying composition of existing indices, by refinement of the indices, or by the creation of new indices. The principal UK indices are prepared by FTSE Ltd, a private company. It is not easy to identify objective rules which would fully deal with the issues respondents identified.

5.13. The London Stock Exchange no longer has a monopoly of trading in securities listed on it. There are several competing electronic exchanges, of which the largest is Chi-X. The central purpose of MiFID, the EU directive which governs much of the regulation of market practice, is to promote competition between exchanges across the European single market.

5.14. In a number of discussions, participants were sceptical about the advantages of such competition. They expressed the regret that the older model – in which the exchange was a utility, existing to serve the needs of market participants in the first instance and then the economy more generally – had been displaced by one in which exchange services were a standalone business. Royal London described their experience as one in which “exchanges have shifted to being commercial activities rather than being organisations owned by users so the incentives have changed and finding ways of encouraging and facilitating greater trading is seen as an end in itself”.

5.15. Electronic trading has made possible the development of high frequency trading. Figures presented us indicate that such trading now accounts for over half of volume on the London Stock Exchange. High frequency trading uses computerised algorithms to make buy and sell decisions more quickly than any human. The speed of reaction is so critical that the physical location of the computer matters because electronic communication even over a short distance takes time. However not all algorithmic trading is high frequency trading: a long term investor may use such an algorithm to increase or reduce a position with timing and qualities consistent with the trading volumes manageable in the stock

concerned. High frequency trading is characterised by complete automation, low margins, rapid and repeated stock turnover, and little or zero overnight exposure.

5.16. Many respondents were critical of high frequency trading, some vehemently so. Supporters of high frequency trading claim that it increases liquidity and reduces price volatility. They point to the very low spreads now quoted on many popular stocks. We only received one submission from a business specialising in high frequency trading. This argued that such trading made a significant contribution to market efficiency.

5.17. The majority of our respondents were sceptical of these claims. They asserted that overall volatility had not been reduced, and doubted that the liquidity which high frequency trading claimed to provide was real. A representative comment was made by Aviva: "while some argue that spreads have reduced as a result of this activity, in reality the extent and depth of liquidity they really represent is questionable". The 'flash crash' of 6th May 2010 in the US stock market was a subject of particular concern, although there is still some doubt about the precise role that high frequency trading played in that event.

5.18. While the tone of submissions was hostile to high frequency trading, there were few suggestions as to how the volume of such trading might be reduced or the activities of high frequency traders restricted. One proposal was that orders, once placed, might be required to rest for a minimum period of time.

5.19. We note that the Government Office for Science is currently undertaking a project examining the future of computerised trading in financial markets, and will frame our assessment in our Final Report in the light of its conclusions. Our concern, however, will be with how such trading can best serve the interests of the customers of equity markets – listed companies and savers.

5.20. High frequency traders seek to gain advantage over other shareholders and potential shareholders through proximity and communications. Asset managers with other styles seek to gain advantage through their knowledge of companies. However their ability to use information of the latter kind is restricted by market abuse rules, which restrict trading on non-public information and prohibit dealing when in possession of sensitive information provided by the company which has not previously been made public.

5.21. One major asset management firm provided an illuminating illustration of how insider dealing rules inhibit engagement. The asset manager, dissatisfied with the performance of a company, had taken steps to bring about management changes. These changes had been agreed but not yet announced and the asset manager was therefore felt obliged to stop list the company, i.e. to block fund managers from buying or selling the shares. Staff at the asset manager who wished to sell the shares because of its poor performance were unable to do so, with the result that their clients suffered a loss when the company simultaneously issued a substantial profit warning alongside the announcement of the management changes. This suggests that the principle of equal treatment of shareholders is in

conflict with the objective of more effective shareholder engagement. This principle seriously limits the advantage which an engaged shareholder can obtain from such engagement.

5.22. Many respondents raised this issue. We were told that "the Asset Managers and Investors Council feels that it has been difficult to have effective engagement with companies on the basis that they are unable to mention anything that has not yet been reported in the press, or are scared about being liable for spreading inside information". Kanes Capital, specialising in smaller companies, observed that "both parties now err on the side of caution...this caution can become an obstacle to discussion of long term strategy". Some other respondents, however, felt that the problem was exaggerated.

5.23. It is possible to distinguish between 'insider' activity which seeks to enable investors to benefit from the supportive stewardship relationship (which our respondents believed was necessary to fulfil the public policy objectives of high performing companies and enhanced returns to savers), and 'insider' activity which represents criminal breach of fiduciary duty (as when persons purporting to act as corporate officers and advisers are in fact using these positions to make undisclosed financial gains for themselves or their associates). The responses we received suggest a legitimate concern that revulsion against the latter, fraudulent, activities may have led to inappropriately restrictive regulation which inhibits the former, publicly beneficial activities.

5.24. Similar concerns were expressed to us about the concert party rules. The Takeover Panel requires a group of shareholders acting in concert who hold more than 30% of a company to make a bid for the whole company. The Panel assured us that this rule is not intended to restrict the ability of major shareholders or asset managers to act together to improve company performance. The Panel is, and will continue to be, ready to give clearances in such cases, and sought to clarify its position through a Practice Statement issued in 2009.

5.25. Some respondents felt that this promised sufficient reassurance – but not all did, and those who did not included some leading asset managers. The point was made that concerns that a group of shareholders might take effective control of a company and use that control to advance their own interests rather than those of shareholders as a whole – the concerns the mandatory bid requirement seeks to address – might be better addressed by strengthening the protection available to minority shareholders.

5.26. It was suggested to us in discussion that complaints about insider trading and concert party rules were simply an excuse. While there may be something in this, the search for excuse might in itself be an indication that incentives for engagement are insufficient.

6. Asset managers

6.1. Asset managers play a central role in modern equity markets. There are many different kinds of asset manager. One important distinction of style is that between ‘long only’ asset managers and those who may take ‘short’ positions.

6.2. Historically, most asset managers were ‘long only’. These managers were employed by pension funds, life companies and collective investment funds – unit or investment trusts – or acted on behalf of these institutions. They built portfolios of shares and bonds and were normally long term holders. Many of these funds and companies have split off their asset management arms into separate businesses which compete for clients in the general market place.

6.3. The first hedge funds mostly took positions based on anticipated macroeconomic events. Today, however, there are many different hedge fund styles and hedge funds are distinguished from other assets mainly by their high fees, offshore registration, and a wealthy client base. Some hedge funds take short positions in equities, to reduce their exposure to overall movements in a sector or the market, or to exploit a negative opinion about a particular company.

6.4. Short selling has received considerable negative publicity, and some of our respondents took the view that the opportunity for asset managers to engage in, or facilitate, short selling of a company’s shares inhibited that company in taking long term decisions. They cited ‘bear raids’, in which short sellers acting in concert drive down the value of a stock and create or aggravate the corporate problem from which they seek to profit. Others argued that short sellers may often have a more informed and longer term view of the business of a company than analysts who have an interest in promoting stocks in the hope of gaining corporate business.

6.5. Our discussions do not suggest that hedge funds are necessarily more short term in outlook, or less interested in the fundamentals of corporate performance, than traditional fund managers. Many are, some are not. The style of the asset manager may be a more important issue than the classification of the type of fund that is managed.

6.6. We are inclined to the view that the most important distinction in the styles of asset managers is that between those whose primary focus is on the activities of the company – its business, its strategy, and its likely future earnings and cash flow – and those whose primary focus is on the market for the shares of the company – the flow of buy and sell orders, the momentum in the share price, the short term correlations between the prices of different stocks.

6.7. The IMA suggested that “a distinction should be drawn between those who mainly trade shares (for example, banks and other proprietary traders) and those, like asset managers, that invest. Proprietary and principal traders that buy or sell

equities with their own capital, including hedge funds and those with high portfolio turnover such as 'high frequency traders', tend to be driven by short-term market trends and turn their portfolios over rapidly. They will not tend to analyse underlying performance. Those that invest also buy and sell equities but tend to hold them for the long-term based on their analysis of a company's prospects and underlying performance."

6.8. We think this identification of traders and investors is helpful and important. It is investors who directly serve the purposes of equity markets in improving the performance of companies and generating returns to beneficiaries, and it is investors who obtain the information which is needed if share prices are to reflect the fundamental value of companies. There is also an important role for traders in making markets and providing greater liquidity for investors. The expansion of the volume of trading relative to investing is the principal explanation of the steep fall in the average holding period of shares. We received evidence that this has narrowed spreads – the difference between buying and selling prices. However given the increase in the overall volume of trading activity, it is not clear whether the effect is to reduce the total cost to investors of market making. We would welcome evidence on this point.

6.9. The IMA submission above implies, however, that all asset managers are 'investors', in the sense in which we – and they – use the term 'investor'. We do not agree. Many asset managers are investors in this sense, but not all are, and the styles of some reflect a mix of trading and investment. Nor do we agree that the distinction between trader and investor can be equated to the distinction between those who use their own capital and those who manage funds on behalf of others. This may have been true before the 'Big Bang' when there was a strict demarcation between market making and other forms of financial activity but the blurring of these lines has been a central feature of the recent evolution of equity markets.

6.10. Not all investors need have long holding periods in mind. An activist investor who seeks changes in strategy or management may anticipate that the effects on share prices will be felt in a short period and plan an early exit. But investors tend to hold shares for much longer than traders.

6.11. This distinction between investors and traders is not clear cut. All investors consider the timing of their purchases and sales in the light of market conditions, and many arbitrage trading strategies are based explicitly or implicitly on characteristics of the company. But the differences in preoccupations and activities are nevertheless marked.

6.12. Many respondents pointed out the steady decline in the average holding period for which shares are held. The IMA, and the CFA Institute, pointed out that this figure may not have the significance commonly attached to it, and has been further distorted by the growth of high frequency trading. We accept these criticisms of this measure. We are inclined to the views that the most helpful measure is probably the proportion of shares which have been held by the current holder for a

specified length of time. That proportion may be, and probably is, a good deal higher than might initially be suggested by the average holding period figure.

6.13. That concept is itself complicated by the multiple dimensions of ownership identified in Chapter 2. If – for example – two years is taken as a minimum holding period consistent with a meaningful relationship with the company, we might go on to ask:

- What share of the economic interest in a company is held by investors who have maintained that economic interest for at least two years?
- What share of the voting rights in the company is held by individuals and institutions which have held these voting rights for at least two years?
- What proportion of the shares is held at the discretion of asset managers whose significant commitment to the company goes back more than two years?

and expect that there might be different answers to each of these questions.

6.14. At present, data does not exist which would enable us to answer any of these questions, far less identify trends in them, and such information could not be extracted from existing data sources. We would welcome comments on this approach, and suggestions as to how data collection might be improved to enable a better understanding of the nature of UK equity markets.

6.15. In 1972 James Tobin proposed a small tax on financial transactions to discourage speculative activity which became widely known as a 'Tobin tax'. Tobin acknowledged that his idea was derived from Keynes, who had made a similar proposal aimed at limiting speculation in UK equity markets: Tobin, however, was mainly concerned with foreign currency transactions following the collapse of the fixed exchange rate system.

6.16. Recently campaigners have revived this idea of a general tax on financial transactions under the label of the 'Robin Hood tax'. These campaigners appear to envisage the tax as a means of raising revenue rather than the regulatory device envisaged by Keynes and Tobin.

6.17. Britain already has a tax on transactions in UK equities in the form of Stamp Duty and Stamp Duty Reserve Tax. Stamp Duty originated as a tax on documents, and is still levied when shares are issued in registered form. Prior to the deregulation of UK securities markets in 1986 (Big Bang) jobbers made markets in equities. They were members of the London Stock Exchange and, like other members of the exchange, were restricted to their specialist function of matching buyers and sellers under the rules of single capacity. Their activities were exempt from Stamp Duty. After 'Big Bang', jobbers became market makers and were absorbed into financial conglomerates. They carried the Stamp Duty exemption with them and transactions by market makers remain exempt. When electronic clearing and

settlement was introduced in 1996 stamp duty was supplemented by a levy on electronic transfer, stamp duty reserve tax. Most tax revenue from equity transactions is now derived from SDRT. Total revenue from stamp taxes on equities in 2010-11 was around £3bn, around half of one per cent of total UK tax revenue.

6.18. This figure is a little over 0.1% of total turnover in UK equities in that year, suggesting that only slightly over 20% of the value of UK equity transactions attract stamp duty or stamp duty reserve tax. If this figure is compared with the headline rate of 0.5%, it might appear that the UK government is missing out as much as £10bn of tax revenue. But this figure is illusory, since if tax were levied on all equity dealings at 0.5% many of them would not take place. The rate of 0.5% far exceeds a normal margin in high frequency trading, for example.

6.19. One respondent described stamp duty as a tax on pension funds and private individuals. The incidence of stamp duty is principally on savers, pensioners and the companies which sponsor pension funds.

6.20. The idea of a more general tax on financial transactions has been adopted by the European Commission and draft legislation has been issued. The Commission has both revenue and regulatory purposes in mind.

6.21. The European Commission's proposal is for a general financial transactions tax at a low rate. The Commission suggest that general financial transactions should bear a levy of 0.1% and derivative transactions a lower rate of 0.01% on the effective value of the risk exposure. This plan was opposed by all respondents who commented on it. However we received little explanation of the reasons for that opposition beyond a general, and understandable, distaste for new and additional taxes.

6.22. A practical problem for such a tax is the opportunity to trade economic interests in UK equities outside the EU. ADRs are UK registered shares held in the name of a US custodian. Interests in these holdings can be traded in New York: the market in ADRs developed when it was still unusual for US investors to hold UK shares directly.

6.23. After the abolition of exchange control in 1979 there was increasing use of ADRs by UK investors to avoid stamp duty. In 1986 a 1½% tax was imposed on transfers of UK shares into alternative clearing and settlement systems. The objective was to limit such avoidance. Financial innovation since then has made the wider implementation of a transactions tax harder in some respects and easier in others. The detail of implementation is critical to any assessment of the merits and consequences of such a proposal.

6.24. Private equity owners are investors rather than traders, although there is a growing secondary market in private equity participations. Like hedge funds, private equity stands out for the level of fees which are charged: percentage management charges and profit shares which may be necessary to compensate

for the fixed costs of monitoring small companies in considerable detail, yield very large sums when applied to large businesses.

6.25. Private equity can provide a framework with which managers can take long term decisions free of the pressures associated with a stock exchange quotation. Indeed private equity, with concentrated ownership structures and performance review by individuals intimately acquainted with the company and committed to its success, resembles in many respects the stewardship model which many respondents wished to see applied to listed companies.

6.26. But at the same time, private equity has been criticised for its short term focus. Respondents told us that managers of businesses owned by private equity were under pressure to restrict investment in the business in order to show immediate increases in earnings, to allow the private equity manager to achieve a quick refinancing or early exit. Sometimes, we were told, this led to pressure to replace equity with debt.

6.27. It is possible that both these things are true. On the one hand, private equity can provide good opportunities for long term decision making: on the other hand, it can do the reverse. The private equity manager is expected by his investors, or the asset managers who in turn allocate funds to private equity investment to him, to return cash or show an objective basis – a transaction or similar event – for an increased valuation. Since much of the return to private equity managers is in the form of 'carried interest' which crystallises only on realisation, the private equity manager may himself have an incentive to achieve this outcome as quickly as possible.

6.28. The critical issue may therefore be not so much the relative merits of private equity and public markets, but the structure of the relations between asset managers and those who provide the funds they manage. The reporting requirements of those who represent the beneficiaries of equity investment may impose time horizons shorter than those of either the beneficiaries or the companies in which they invest.

6.29. The growth of private equity is in part a response to perceptions by corporate managers of the disadvantages of public markets for company decision making and of a preference by investors for vehicles for corporate equity investment opportunities outside the public market framework. There is now an active secondary market in private equity participations. There are obvious respects in which private equity structures today resemble what public equity markets once were, with a sharp distinction between investment and market making and a much greater role for the former. Perhaps the demarcation between private equity and public listing is unnecessarily sharp.

6.30. The CFA Institute reported the result of a survey of their members, mostly employed in equity research or fund management. Half of these respondents said that the time horizon on which they based buy or sell assessments was less than a year, and for only 30% did that timescale exceed two years.

6.31. As emphasised in Chapter 2, the observation that different agents in the investment chain employ different time horizons, and that many of these are short, is not in itself evidence of a problem. A key function of secondary markets in equities is to provide liquidity, in the basic sense of that word – to allow the time horizons of investors in companies to be different from the time horizons of the companies themselves.

6.32. The concern which was expressed or reflected in many of the submissions we received was that the time horizons adopted by savers, or their representatives, to judge their asset managers was significantly shorter than the time horizon over which the saver, or the corporate sponsor of a pension scheme, was looking to maximise a return. This emphasis by savers or their representatives on short term performance investing influenced the style of asset management in ways that could disadvantage the beneficial owner. The shorter the time scale, they suggested, the greater the incentive to adopt strategies which emphasise trading rather than investing.

6.33. The metrics on which asset managers are judged are as important as the timescales over which these metrics are applied. Many respondents told us that asset managers were typically measured by their performance, relative to a specified benchmark. These benchmarks are usually based on indices, which in turn are closely related to the average performance of all investors in that asset class. We were reminded of the case in which the Unilever pension fund recovered damages from Mercury Asset Management because the asset managers appeared to have failed to adopt adequate measures to relate performance to the agreed benchmarks. Investment consultants employ benchmarks and compare the performance of different asset managers. Implicitly or explicitly, asset managers are judged by their performance relative to other asset managers.

6.34. This emphasis on relative performance appears to be found at every point in the investment chain. Advertising to retail customers stresses the relative performance of the promoted funds. Financial intermediaries give advice on a similar basis. Trustees and other representatives of beneficiaries hire managers by reference to their recent performance relative to other similar managers, and are guided in this choice by consultants who construct databases for this purpose. Agents of beneficiaries then monitor asset managers via benchmarks. The central role of relative performance in the business models of asset managers is mirrored in the bonus structures applied to individual fund managers with asset management companies.

6.35. We noted that the words ‘relative’ and ‘absolute’ were used in two different senses. Relative performance may be defined as performance relative to a benchmark index in contrast to absolute performance, the total return generated by a fund or portfolio. Hedge funds generally described their objective in terms of absolute returns, and the terms hedge fund and absolute return fund are sometimes treated as synonymous. Relative performance may also refer to the performance of a fund relative to other funds pursuing similar asset classes or

investment strategies. Thus it makes sense to talk about the relative performance of an absolute return fund, and indeed commercial hedge fund indices are published to facilitate such assessment.

6.36. The emphasis on relative performance is reinforced by regulation and other external pressures. Respondents told us that the greater obligations on trustees to seek professional advice, and the general extension of transparency and disclosure requirements, has led to much more extensive benchmarking, performance monitoring, and use of consultants. In asset management firms, 'risk' is generally measured as tracking error relative to a benchmark. One large firm which pursued an investment strategy based on stewardship of a concentrated portfolio told us that it had recently been required to introduce a risk management system of this kind, although they believed it had no relevance to their risk control processes implemented by their investment team. The firm commented that the long term past success of their stewardship approach, and the limits on portfolio risk implicit in it, was not a subject which had ever been mentioned in regulatory discussions.

6.37. One large fund manager put it particularly clearly "for beneficiaries, the risk is that such a mandate will not deliver the returns that at least match the liability. For the investment manager, the risk is underperformance against the selected benchmark". We were told that the result of all these pressures was frequent resort to 'closet indexation'. Although those who appointed asset managers were seeking – and paying for – active management, the portfolios that were constructed for them tended to follow the index.

6.38. Many of the issues which concerned respondents, and which are at the heart of the questions for this Review, are the product of this emphasis on relative performance. While returns to beneficial owners, taken as a whole, can be enhanced only by improving the performance of the corporate sector as a whole, returns to any subset of beneficial owners can be enhanced, at the expense of other investors, by the superior relative performance of their own asset managers. The search for superior relative performance drives the business models of asset managers, and is reinforced by regulation and the widespread practice of benchmarking. Even if the benefits of stewardship would be large, for both companies and beneficiaries, the incentives for any individual fund manager to pursue these benefits are weak, since although the individual fund manager bears all the costs most of the additional return will accrue to people who are not his clients and most of the business benefits will accrue to other firms.

6.39. The structure of the industry favours exit over voice, and gives minimal incentives to stewardship. Many respondents clearly regarded engagement with companies as a cost. One of the largest UK asset managers, with both active and passive funds under management, told us that "engagement with investor companies requires investment of time and resource which can be seen as an encumbrance in a situation where mandates are being awarded based on fees". Many of these nevertheless accepted it as a responsibility of the asset manager: some thought it should be paid for, as a distinct charge or a levy on all investors. A few

respondents suggested that there was some evidence that activist fund managers could recover the costs of strong engagement through superior performance. We noted the obstacles to doing so in Chapter 2 above.

6.40. This lack of incentive for engagement is an inescapable feature of an investment landscape characterised by a competitive fund management industry and the fragmented holding of shares. Many respondents commented that the increased fragmentation of ownership had aggravated this problem.

6.41. The suggestions of those who expressed concern about such free riding, and the underinvestment in engagement which follows from it fell into four main categories. Some felt there should be specific advantages conferred by companies, through fiscal measures, or through regulatory changes, on shareholders who were willing to make a commitment to engagement, thus diminishing the 'free-riding' problem. Some measures of this kind are discussed in Chapter 3.

6.42. A second approach would facilitate, or even compel, groups of shareholders or their agents to act collectively. Some possible measures designed to achieve this are also discussed in Chapter 3 above.

6.43. Yet another way to mitigate the problem would involve an attempt to create a less dispersed pattern of shareholding. In discussions, we were told that the UK is an outlier among large economies in the degree of dispersion of shareholding. In continental Europe ownership of substantial blocks of shares by families and large financial institutions is common. Family ownership of significant scale is still common in the US outside the very largest companies.

6.44. There are many features of British economic and social history which have contributed to this decline of shareholding blocks. One factor was the traditional strong opposition by British investment institutions to structures involving multiple share classes. If the result of such opposition was that founders could not maintain a controlling interest in the company, they were more inclined to reduce their economic interest.

6.45. Another approach to dealing with free riding would encourage fund managers to hold more concentrated positions. Regulations for diversification and liquidity of retail funds, for example, may be more demanding than those necessary to achieve the maximum benefit for investors. Trustees might be encouraged – or required – to take a more active interest in the companies in which their funds are invested, and hence to put pressure on their asset managers to do so.

6.46. The growth of passive fund management – the construction of portfolios which seek to replicate indices – concerned some respondents. One submission even advocated that a "health warning" be attached to communications to beneficiaries by such asset managers to the effect "that such funds and strategies do not take into consideration the underlying competitive strengths of the individual companies which comprise the risk assets to which the beneficiary is exposed".

6.47. In some discussions, queries were raised as to whether the UK market indices should have the influence they do on the structure of the portfolios of UK resident savers. We were reminded that most of the profits of FTSE 100 companies taken as a whole were now earned outside the UK and that some – including a number of recent large introductions – have no real connection with the UK at all. Diversification suggests that UK residents should invest some – perhaps all – of their assets outside the UK. However many UK residents might positively wish to invest in the UK and it may be to the benefit of the UK economy that they do. Many countries have measures which reinforce the natural home bias of the investment decisions of their citizens. There is some evidence that UK based managers will do better, relative to their benchmark, in the UK markets than in overseas markets.

6.48. Whatever the balance of these factors, it is likely that for the foreseeable future the construction of the UK indices will have considerable influence on the composition of the portfolios which aim to meet the needs of long term savers in the UK. This issue gains force from the rise in the role of defined contribution schemes in the provision of pensions.

6.49. It is in the nature of passive management that 'exit' is not available as a means of engagement. However the two largest passive managers – BlackRock and Legal and General – made submissions in which they emphasised that the very nature of passive management obliged them to be long term holders of shares. The existence of that obligation encouraged them to use 'voice', and to engage more effectively with the many companies in which were among the largest shareholders. We were in no doubt that these companies took corporate engagement seriously. They have the scale to mount engagement activities at a cost which is a very small fraction of their funds – passive or active – under management.

6.50. Such engagement is governed by the stewardship code, which was published by the Financial Reporting Council in July 2010. Many respondents expressed satisfaction with the code, within the terms of its objectives, and felt that it should be given time to settle.

6.51. Some concern was expressed in discussion that there tended to be a separation between the stewardship and investment activities of fund managers and indeed rules on insider trading may encourage this (see Chapter 5 above). In some institutions, the stewardship code was implemented by corporate governance specialists, who might be divorced from the understanding of the business of the company held by the investment managers and were not party to buy and sell decisions. The largest firms with such organisation structure assured us that there was close contact between the two groups. In other firms, the two elements of stewardship and investment were combined. We did, however, recognise a concern from both listed companies and fund management businesses that the issues raised by the stewardship code emphasise the formalities rather than the substance of board appointment and decision-making.

7. Intermediaries

7.1. Most UK equities are held through intermediaries. Even individual holders who make their own investment decisions must operate through an intermediary, employing either a sponsoring broker for personal CREST membership or, more frequently, using the services of a nominee.

7.2. There are many intermediaries, and many levels of intermediation. The Review has found it useful to identify four broad groups of intermediary.

- **Holding agents.** These intermediaries play no role in investment decisions, but facilitate investment and assume safe keeping of securities. This category includes nominees, custodians, and trustees of retail funds. Platforms have become an increasingly important feature of the way retail investors access investment products and may be regarded as another means by which beneficiaries hold securities through intermediaries.

- **Asset managers.** The activities of asset managers were discussed in Chapter 6.

- **Administrators and representatives of beneficiaries.** This group includes the many insurance companies and other retail funds which contract out the actual management of the funds for which they are responsible. It also includes pension trustees and pension administrators. These intermediaries select asset managers, and review their activities, but are not themselves the principal agents in asset management.

- **Retail agents.** These are the individuals or businesses which deal directly with beneficiaries. This group includes financial advisers and other product distributors, such as retail banks.

7.3. Beneficiaries may use the services of some, but not all, of these groups of agents. Or they may encounter several tiers of intermediation within one of these groups – as when they employ a nominee or platform to hold their investments in a fund which itself uses a nominee and/or a custodian, or when their asset manager subcontracts some or all of the investment choice to another asset manager.

7.4. All intermediaries engage the services of other agents in the process of performing their own services. All must use accountants and lawyers and engage in regulatory compliance. In addition, each group – except for holding agents – employs advisers and buys other investment related services. Companies use investment banks, asset managers buy trading services and make use of stock analysts. Trustees employ actuaries and investment consultants. Trustees and asset managers may make use of proxy services. Administrators use investment banks to construct structured products based on derivatives. Most financial

advisers are now either employees of financial conglomerates or, if independent, are part of larger groupings for regulatory and other purposes.

7.5. The existence of these intermediaries is in itself neither necessarily good nor bad. They can fulfil key functions effectively – or be a source of cost. They have become increasingly important elements in the investment chain, but company law – which simply relates to the company and its shareholders – has effectively ignored their growing role.

7.6. The length of the list of intermediaries raises many questions. Some arise directly from the review's perspective that equity markets exist to enhance corporate performance and reward beneficiaries. Is the value of this intermediation activity commensurate with its costs? Does the interposition of many intermediaries, with business objectives which are not necessarily aligned with the interests of companies and beneficiaries, conflict with the underling objectives of promoting these interests? Many submissions raised issues under one or other of these headings.

7.7. Some of the increase in intermediation activity has been caused by the growth of regulation. Many respondents were unhappy about the increased burden of regulatory compliance. They also pointed to consequential expenditures: for example, the increased responsibilities imposed on pension trustees by regulation have led to increased reliance by them on scheme actuaries and investment consultants. The duties of the custodians of fund assets have recently been extended, raising the costs of custody.

7.8. Regulation has indirect costs. In Chapter 4 we noted the concern expressed in many submissions about the reduction in equity exposure which is a likely consequence of Solvency II. The possible extension of these developments to pensions was a matter of further concern. The principal motivation of these measures appears to be to reduce the probability of failure of an institution – the cost of which would fall mainly on the various financial compensation schemes. But this public objective may be achieved, if it is achieved, at disproportionate cost to companies and the majority of beneficiaries of schemes which do not fail.

7.9. Regulation is not the only, and probably not the most important, reason for the proliferation of intermediary activities. There was wide agreement that the overall costs of intermediation had become excessive – although we were presented with little specific evidence on this point – with attention focused particularly on three areas.

- the fees of investment bankers, for issuance, underwriting, financial restructurings, and for their advisory role in mergers and acquisitions

- the costs of market making, with emphasis on high frequency and other short term trading

- the charges made and commissions paid in the retail distribution sector

We received less criticism of charges by asset managers, although some respondents were concerned by the fees charged by hedge funds and private equity managers. We were impressed by the widespread and vehement criticism of investment banking fees.

7.10. Many respondents felt that transparency and disclosure about charges were the best means of ensuring that such charges remained commensurate with the value of services provided. Historically, there has been very little transparency or disclosure in relation to investment banking fees, or measures of the costs of market making (some respondents claimed that the profitability of high frequencies trading relied significantly on the rebates paid by some exchanges for the provision of liquidity). Recent changes made by the Takeover Panel will provide greater transparency on fees associated with takeovers. One of the central purposes of the Retail Distribution Review (RDR), currently in process of implementation, is to establish more transparency in the cost of retail distribution and financial advice.

7.11. Asset managers serving retail customers are required to publish their total expense ratio (TER), which includes the management fee and some other administrative charges which are passed on to investors. Some respondents pointed out that not all costs are included in this calculation. Additional costs may include charges on entry or exit, or the variety of costs such as commissions, and market spreads – associated with dealing. These respondents suggested that alternative measures might provide a higher and more illuminating measure of intermediary costs associated with asset management.

7.12. A few respondents – mostly individuals – observed that individual remuneration through the investment chain is high. They observed that the costs of intermediation would be less if the rewards of employees were less – or that the rewards of employees would be less if the costs of intermediation were less. The Financial Service Consumer Panel took the view that “the financial services sector is subject to many kinds of market failure, arguably more than other sectors of the economy”. The Panel went on to suggest that “there is an argument that some financial innovations tend to benefit the innovator more than the client as a result of opacity, complexity, oligopoly, asymmetry of information and problems associated with principal/agent relationships”. The Panel thought that the appropriate remedy was more clarity and transparency throughout the investment chain, and the vigorous promotion of competition by the Financial Conduct Authority.

7.13. Asset managers and fund administrators routinely engage in stock lending. This involves transferring the legal title, but generally not the underlying economic interest, for a transitional period to a third part in return for a fee. A principal rationale for this practice is to permit others to undertake short selling.

7.14. Many respondents were strongly critical of stock lending. Some were critical of stock lending because they were critical of short selling. They took the view that it was wrong for investors to facilitate the practice of short selling, especially since

the stock in which the short seller was trading was one in which investors lending the stock had a long interest.

7.15. Others were concerned about fees and risks. They pointed out that there was often no alignment, and perhaps conflict, between the interests of the fund manager and the client. They told us that the fees received for stock lending were often retained in whole or in part by the fund manager or administrator, while the risks, fell on and remained with the beneficiary. The principal risk is that the counterparty fails to return the stock while the collateral lodged proves insufficient to cover the loss. Of course, anticipation of fees from stock lending may prompt the asset manager to offer lower management charges, and it is the risks and rewards of the asset management contract taken as a whole that is relevant to the ultimate beneficiary.

7.16. In Chapter 6, we discussed the potential mismatch between the business models of asset managers and the interests of companies and beneficiaries. These tensions between the interests of intermediaries and the interests of companies and savers extend widely. Investment banks are remunerated principally on transactions. Market makers earn their profits through trading. Insurance companies and fund administrators focus on the volume of new business, and their revenue models are designed around this. Financial advisers are remunerated mainly from transactions. The RDR is likely to lead to a shift to fee based advice but it will still be true that financial advisers will generally earn more when the saver undertakes a transaction than when he does not. A common feature of all these structures is a bias towards action: the more the client does, the more the adviser or agent is paid.

7.17. Several respondents proposed that the concept of fiduciary duty should be employed more widely in the investment chain. That obligation is a creation of the common law. It is the highest standard of agency relationship the law allows, and obliges the fiduciary to place the interests of the client before his or her own. A trustee has a fiduciary duty in relation to his or her beneficiary, a company director in relation to his or her company. Fiduciaries have a particular obligation to avoid conflicts of interest. Whether a relationship has fiduciary character rests on the fact of a particular case, although the fiduciary position of the trustee and the company director has been clearly established through precedent.

7.18. Such fiduciary duty might be extended to the relationship between fund manager and client – a relationship which at present is believed normally to be defined by the terms of the contract between them. The AMIC told us that “the industry represented by the AMIC has a fiduciary duty to its clients”. But there were divergent views on this issue. Hermes provided a nuanced account of the situation: “While on the face of it, fund managers are burdened with fiduciary duties through the simple fact that they are looking after money on behalf of others, not all accept the analysis, and in many ways the fiduciary duties are crowded out or limited by the specific terms of the contractual relationship”.

7.19. The nature of the fiduciary relationship between pension fund trustee and members was of particular concern to some respondents. FairPensions provided an extended submission on this issue. They argued that the case of Cowan v. Scargill [1985], in which the Court had rejected the claim by Mr Scargill that union representatives could insist on wide disinvestment by the Coal pension funds, had encouraged trustees to take a very narrow view of their obligations. This had been reinforced by subsequent litigation about the management of Church of England investments – Harries and Church Commissioners for England (1992) 1WLR 1241. The Church of England told us that “there is insufficient guidance on what the fiduciary obligations of charity and pension fund trustees entail and mean”. In discussion, several senior lawyers told us that a narrow view of trustee obligations which focussed only on immediate financial gain was not an accurate reflection of the legal position. However FairPensions provided evidence that some trustees did in fact take the narrow view and our discussions gave some support for that contention. We noted earlier that legal advice is often very risk averse in its interpretation of the law. One very senior lawyer experienced in the field told us “the investment structure encourages trustees to act on unchallenged professional advice; advice characterisable as devised more for the convenience of the advisers than the interests of the beneficiaries”

7.20. FairPensions was one of a number of respondents who suggested that a version of the ‘enlightened shareholder value’ concept contained in the specification of directors’ duties under the Companies Act 2006 might be extended not just to pension fund trustees, but to other intermediary agents.

7.21. Fair Pensions also expressed concern about the influence of trustees of what they described – following US academic Keith Johnson – as ‘the lemming standard’. The ‘prudent man’ standard required of trustees not only leads them to take advice when they might rely on their own judgment but also to follow the practice of others in a similar position. Both factors lead to herding behaviour – trustees take similar views at the same time, often for little better reason than that others hold these views. The Co-operative Asset Management was particularly scathing in its description of the present position: “Prevailing interpretations of fiduciary duty are stuck in the past, ill equipped for the modern day investment environment and pernicious to the wider market. We believed that a misguided understanding of the duty of prudence (resulting in short term focus on short term investment performance appraisal) has increasingly conflicted with the fiduciary duty of impartiality”.

7.22. Analysts have always played an important function in the equity investment chain. Market parlance distinguishes ‘sell side’ analysts – who work for brokers and banks engaged in transactions and issuance – from ‘buy side’ analysts – employed by asset managers. We expected to hear a good deal about the activities of analysts, who have traditionally been the interface between investors and companies. We did not.

7.23. Originally sell side analysts were employed by stock broking partnerships, to generate ideas for the brokers’ sales teams. With the development of financial

conglomerates after ‘Big Bang’ in 1986, many analysts were found in investment banks, with some continuing to work for smaller firms which sought issuance business from companies outside the FTSE 100.

7.24. The role of the analyst has therefore always involved a conflict of interest. Once, that conflict arose from the dependence of the broker’s revenue model on client transactions. Here, the business employing the analyst hoped his work would encourage investors to trade. More recently, the conflict arises when they are employed in a business with a revenue model whose profits are largely derived from corporate activity. In this case, the business employing the analyst hoped his work would encourage companies to transact. The aftermath of the New Economy bubble exposed the extent to which many sell side analysts had been acting as the sales arm for the bank’s corporate finance business.

7.25. The Myners Report brought an end to the general practice of ‘soft commission’, in which brokers paid for services – such as equipment and data – used by asset managers in return for commission payments on transactions (which were charged to the fund). A limited exception, however, was made for research services. Brokers have been required to distinguish payment for research and payment for execution in their commission charges and fund managers have been required to disclose the total of these payments in their reports. The principal purpose of this exception was to stimulate the growth of an independent research sector, which might derive revenue from fees rather than commissions. But while some activity of this kind has developed, its scale is very modest. Most analysts today are employed by asset managers or, more frequently, by investment banks or other firms engaged in securities issuance.

7.26. Several respondents were critical of the quality of analysts’ research, commenting that they tended to focus on short term earnings forecasts and projections. We were told that the obligation on analysts to produce such information required a relationship with the company which made it difficult to take a critical stance. Others, however, emphasised that many analysts were concerned with the development of the capabilities of the business and its competitive positioning.

7.27. A number of services have emerged whose specialist purpose is to vote shares or to advise those who vote shares. Such services have the advantage of being a potential solution to the free riding problem by offering a mechanism for collective action. On the other hand, they add yet another layer of intermediation costs. They may encourage asset managers to feel relieved of any need to seek engagement with investor companies, since this activity has been outsourced, and entrench the idea that engagement is a cost rather than a central feature of investment activity.

7.28. In the UK, this form of intermediation has mostly focused on formal governance issues, such as the separation of the chairman and chief executive roles and the independence of directors. Other such intermediaries have stressed environmental and social factors. In the UK, there has been little development of services which take engagement into issues of strategy. But this may happen, or could be encouraged to happen.

7.29. The retail sector, which deals directly with the beneficiaries of equity investment, has two principal sections. Execution only share dealing services and private client brokers are the main channels through which small investors buy shares directly. Independent financial advisers and the distribution operations of financial conglomerates are the main channels through which small investors buy equity linked funds. Some firms cover both segments. The development of retail fund supermarkets and 'platforms', which are accessed directly by small investors and indirectly through financial intermediaries, has changed and extended the role of intermediary activity for retail investors in equities.

7.30. Several respondents queried whether the value of these services was commensurate with their costs. However all of these noted that the RDR, currently in process of implementation, will bring radical changes to the sector. It is difficult to comment further in advance of an assessment of the effects of these changes.

7.31. The primary question for this Review, however, is the effect on the time scales of investment. The incentives of financial advisers are directed towards activity. This may encourage savers to adopt time horizons for their holdings much shorter than their actual investment horizons, and to attach inappropriate weight to relative performance by fund managers over short time scales. J.P. Morgan provided us with striking evidence on the average holding period of investors in their funds. The holding period for their investment trusts, which are mostly held directly by individual shareholders, was much longer than the holding period for open ended funds, which are mostly purchased with the assistance of financial advisers.

7.32. Many respondents pointed to the costs and conflicts arising from the growth of intermediation. We heard little about the benefits. The financial world has become more professional at all levels, and the quality of the individuals engaged in it and the training they receive has risen. As many respondents pointed out, however, there is a tendency to judge the performance of equity markets by reference to the criteria employed by market participants themselves, rather than by the benefits to end users – the companies which are quoted on equity markets, the savers who directly and indirectly use equity markets to plan for their retirement and provide for their future need. That perspective is one the Review will continue to emphasise.

Annex A: List of responses to the call for evidence

The evidence submitted to the Review may be found at:
www.bis.gov.uk/kay-review-responses

Anglia Ruskin University
Aon Hewitt Investment Consulting
Asset Management and Investors Council
Association of British Insurers
Association of Chartered Certified Accountants
Association of Corporate Treasurers
Association of Private Client Investment Managers & Stockbrokers
Aviva Investors
*Stephen Beer
*Charles Breese
BlackRock
Brewin Dolphin
Carbon Tracker
Cazenove Capital Management
Cevian Capital
CFA Society of the UK
*Charles Cronin
Church of England Ethical Investment Advisory Group
CIS Unit Managers Ltd (The Co-operative Asset Management)
City of London, Law Society (Company Law sub-committee)
Confederation of British Industry
*Peter Cadbury
*Tim Currell
*Christina Dargenidou
*Sir Michael Darrington
*Caroline Egerton
Equiniti
Europapartners
FairPensions
Fidelity
Financial Services Consumer Panel
Financial Reporting Council
Governance for Owners LLP
*Nigel Hastings
Hermes Equity Ownership Services
*Alexander Hopkinson-Woolley
Human Potential Accounting
The Hundred Group of Finance Directors
Institute of Chartered Accountants in England and Wales

Institute of Chartered Accountants of Scotland
Institute of Chartered Secretaries and Administrators
Institute of Directors
Invesco Perpetual
Investec Asset Management
Investment Management Association (IMA)
*Howard Jacobs
J.P. Morgan Asset Management
Kames Capital
KPMG
Legal & General Investment Management
Local Authority Pension Fund Forum
*Martyn Long
Long-Term Practical Perspectives Ltd
M&G Ltd.
MM&K Ltd
*Peter Morgan
*Peter Morris
*Roger Morton
National Association of Pension Funds
Network for Sustainable Financial Markets
*Hans Nilsson
Quakers and Business Group
Quoted Companies Alliance QCA
RPMI Railpen Investments
Royal London Asset Management
RWC Partners Ltd
Schroders Investment Management Ltd
The Share Centre
*Simon Woolley
Standard Life Investments Ltd
SVM Asset Management Ltd
Taylor Wessing LLP
The Society of Pension Consultants
The Takeover Panel
Tomorrow's Company
Trades Union Congress TUC
UK Individual Shareholders Society (ShareSoc)
UK Shareholders' Association
UK Sustainable Investment and Finance (UKSIF)
University of Bath
University of Edinburgh Business School
University Superannuation Scheme
*Martin White
*Robin Woodall
*Christopher Wright

*denotes individual responses

Annex B: Glossary

More information on the terms below may be found at the associated web addresses:

- ADR American Depositary Receipt
  http://investor.legalandgeneral.com/adr.cfm

- Chi-X pan-European equity exchange
  http://www.batstrading.co.uk/chi-xeurope/

- Companies Act 2006
  http://www.legislation.gov.uk/ukpga/2006/46/contents

- Cowan v. Scargill and others [1985]
  www.gwynedd.gov.uk/ADNPwyllgorau/2007/.../05_02_Atodiad.pdf

- CREST – securities settlement system
  http://www.bankofengland.co.uk/markets/paymentsystems/index.htm

- Government Office for Science
  http://www.bis.gov.uk/go-science

- Harries v. Church Commissioners for England. [1992]
  http://www.charitycommission.gov.uk/Charity_requirements_guidance/Charity_governance/Managing_resources/legal_underpinning.aspx

- Initial Public Offering (IPO) market in the UK
  http://www.fsa.gov.uk/library/communication/pr/2008/003.shtml

- MiFID:- EC Investment Services Directive: Markets in Financial Instruments Directive
  http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm

- Myners Review of Institutional Investment: Final Report
  http://archive.treasury.gov.uk/docs/2001/myners_report0602.html

- NOMADs: nominated adviser for the Alternative Investment Market (AIM)
  http://www.londonstockexchange.com/companies-and-advisors/aim/advisers/advisers.htm

- RDR: Retail Distribution Review
  http://www.fsa.gov.uk/rdr

- Solvency II - EC Review to establish a revised set of EU-wide capital requirements and risk management standards for the insurance industry.
  http://www.fsa.gov.uk/solvency2%20

- The Takeover Panel
  http://www.thetakeoverpanel.org.uk/statements/practice-statements

- Tobin Tax: article by the OECD explaining its original purpose
  http://www.oecdobserver.org/news/fullstory.php/aid/664/Tobin_tax:_could_it_work__.html

- UK Corporate Governance Code and 'comply or explain' The UK Approach to Corporate Governance: cited as a principle that emerged from the Cadbury Report (1992).
  http://www.frc.org.uk/documents/pagemanager/frc/FRC%20The%20Uk%20Approach%20to%20Corporate%20Governance%20final.pdf

- UK Listing Authority UKLA, part of the Financial Services Authority
  http://www.fsa.gov.uk/Pages/doing/ukla/index.shtml

- Women on Boards – Independent Review by Lord Davies
  http://www.bis.gov.uk/news/topstories/2011/Feb/women-on-boards

Annex C: Background to the Kay Review

Terms of Reference

June 2011

The terms of reference for the review are:

To examine the mechanisms of corporate control and accountability provided by UK equity markets and their impact on the long term competitive performance of UK businesses, and to make recommendations.

This will include the following areas:

- Whether the timescales considered by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and fund managers in making investment and governance decisions, match the time horizons of the underlying beneficiaries.
- How to ensure that shareholders and their agents give sufficient emphasis to the underlying competitive strengths of the individual companies in which they invest.
- Whether the current functioning of equity markets gives sufficient encouragement to boards to focus on the long term development of their business.
- Whether Government policies directly relevant to individual quoted companies (such as regulation and procurement) sufficiently encourage boards to focus on the long term development of their business.
- Whether Government policies directly relevant to institutional shareholders and fund managers promote long-term time horizons and effective collective engagement.
- Whether the current legal duties and responsibilities of asset owners and fund managers, and the fee and pay structures in the investment chain, are consistent with asset owners' long term objectives.
- Whether there is sufficient transparency in the activities of fund managers, clients and their advisors, and companies themselves, and in the relationships between them.
- The quality of engagement between institutional investors and fund managers and UK quoted companies, and the importance attached to such engagement, building on the success of the Stewardship Code.

- The impact of greater fragmentation and internationalisation of UK share ownership, and other developments in global equity markets, on the quality of engagement between shareholders and quoted companies.

- Likely trends in international investment and in the international regulatory framework, and their possible long term impact on UK equity markets and UK businesses.

Advisory Board

In August 2011 Professor Kay appointed three senior city figures to form an Advisory Board for the review:

- Sir John Rose, former Chief Executive of Rolls-Royce plc

- James Anderson, Partner and Manager at Baillie Gifford

- Chris Hitchen, Chief Executive of the Railways Pension Trustee Company, and Chairman of the Pensions Quality Mark.

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