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

Call for Evidence

Introduction

In June, the Secretary of State for Business, Innovation and Skills asked me to undertake an independent review of the effect of UK equity markets on the competitiveness of UK business. The announcement of the review explained the background:

> *The UK has strong equity markets, which attract leading investors from around the world, and it benefits from an internationally competitive fund management industry. Equity investment is a source of funds for UK companies, and is one of the principal mechanisms through which savers provide for retirement and fulfil their other long term financial goals. Shareholders have a primary role in promoting the accountability of management and boards for the performance of their businesses.*
>
> *The Government wishes to ensure that UK equity markets continue to perform to the benefit of both companies and investors. The Secretary of State has therefore commissioned a review which will consider the ways in which the mechanisms of control and accountability provided by UK equity markets, and the behaviour of the agents in that process, affect the performance of UK business. The review will give particular emphasis to the ability of managers to focus on the actions needed to enhance the long term competitiveness of UK based firms and achieve the best long term returns for UK savers.*

In conducting the review, I am assisted by an advisory board consisting of Sir John Rose, Chris Hitchen and James Anderson. My colleagues and I are now seeking submissions and evidence on the subject raised by the review. Such submissions should be received by 18 November 2011. Our intention is to provide the Secretary of State with an interim report in February 2012, which will describe our preliminary findings and possible recommendations. There will then be a further opportunity for comment before we present a final report in July 2012.

The broad philosophy of the review is described in my speech to the National Association of Pension Funds on 15th September 2011. Both the speech and this document are available online at: www.bis.gov.uk/kayreview

This document expands on the previously published terms of reference for the review, and under the various headings of these terms of reference indicates some of the questions on which we would particularly welcome evidence. These headings are certainly not intended to be exhaustive.

The review will seek to understand the incentives, motivations and timescales of all participants in the equity markets, and how these affect the long-term performance of UK companies. We therefore understand that many different groups of stakeholders are interested in the subject of the review, and that many of the questions which are raised will not be relevant to particular individuals or organisations. We would particularly welcome submissions that assist us in establishing the factual background to the questions we are considering – whether in the form of statistical information or specific experiences – and those which make specific suggestions of recommendations we might consider, or policy changes that the government, or the variety of agencies that exercise public functions in relation to corporate governance or financial markets, might consider.

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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.**

The terms of reference set out ten broad questions for the review to consider. These are set out below**.** In each case this paper sets out those questions and issues on which we would particularly welcome evidence:

1. **Whether the timescales considered by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and asset managers in making investment and governance decisions, match the time horizons of the underlying beneficiaries.**

   We would particularly welcome evidence on:

   a. the relationship between reporting timescales and those used for internal planning and appraisal;

   b. what timescales are used by companies in investment appraisal;

   c. how companies review investment in intangible assets (e.g. corporate reputation, workforce skills);

   d. what timescales are used by equity investors, and in particular institutional investors such as pension scheme trustees, who appoint fund managers in determining investment strategy.

2. **How to ensure that shareholders and their agents give sufficient emphasis to the underlying competitive strengths of the individual companies in which they invest.**

   We would particularly welcome evidence on:

   a. how equity analysts and asset managers assess the competitive advantages of companies;

   b. the extent to which trading on equity markets is guided by analysis of underlying corporate performance, and the extent to which it is driven by analysis of short-term market trends;

   c. how have technological advances such as automated trading affected investment decisions in equity markets;

   d. whether corporate managers feel able to communicate effectively about issues related to the competitive position of their businesses.

3. **Whether the current functioning of equity markets gives sufficient encouragement to boards to focus on the long term development of their business.**

   We would particularly welcome evidence on:

   a. whether changes in reporting obligations have influenced the perspectives and timescales of managers and boards, and whether these changes in perspectives and timescales help or hinder long-term decision making;

   b. how the perspectives of managers and boards vary between listed companies, companies whose equities are traded on AIM and PLUS

c. whether publicly traded companies pay too much attention (or feel obliged to pay too much attention) to short-term fluctuations in their share prices;

d. whether companies feel that their engagement with fund managers and analysts is properly focused on the competitive capabilities of the business.

4. **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 businesses.**

   We would particularly welcome evidence on:

   a. whether government policies encourage undue focus on cost cutting, or otherwise damage the ability of firms to engage in long-term investment and the building of sustainable competitive advantage;

   b. whether government policies aimed at facilitating long-term investment by companies have been effective and whether there are other ways Government could support long-term business growth.

5. **Whether Government policies directly relevant to institutional shareholders and fund managers promote long-term time horizons and effective collective engagement.**

   We would particularly welcome evidence on:

a. whether pension regulation, insurance regulation, supervision of charitable endowments and regulatory requirements for asset managers lead to excessive emphasis on benchmarking and on short-term performance measurement;

b. whether the broader regulation of equity markets has an impact on the investment timescales of market participants;

c. whether the regulation of contact between companies and investors is an obstacle to effective engagement.

6. **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 these long-term objectives.**

   We would particularly welcome evidence on:

   a. whether there is a more rapid turnover of asset managers and whether this makes it more difficult for these managers to take a long term view of the companies in which they invest;

   b. how individual asset managers are rewarded, and their performance measured, and whether this gives insufficient incentive for them to take a long term view of the companies in which they invest;

   c. whether there are agency problems in the objectives and operations of asset managers that may be deleterious to the interests of the corporate sector or savers;

   d. how other intermediaries and market participants are remunerated and what impact this has on their incentives and those of their clients.

7. **Whether there is sufficient transparency in the activities of fund managers, clients and their advisors, and companies themselves, and in the relationships between them.**

We would particularly welcome evidence on:

a. whether the existing rules on disclosure of material stakes are excessive or inadequate;

b. whether asset managers should be subject to more extensive disclosure requirements, e.g. of costs and remuneration structures;

c. whether the growth of investment consultants has encouraged or discouraged engagement by share owners with companies;

d. whether the overall costs of intermediation are understood by beneficiaries, and are proportionate to the value of the services provided;

e. whether investors have sufficient information to understand the investment approaches of asset managers and to judge whether they are aligned with their investment objectives and timescales.

8. **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.**

We would particularly welcome evidence on:

a. whether the measures taken to stimulate engagement by investors with companies have been sufficiently effective;

b. whether the corporate governance activities of asset management businesses are sufficiently integrated with the decisions of fund managers.

9. **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.**

We would particularly welcome evidence on:

a. what has been the effect of the internationalisation of UK equity markets on the priorities of companies and fund managers;

b. whether the growth in overseas ownership of UK equities, and in the overseas activities of UK listed companies, has affected engagement between UK investment institutions and UK companies.

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

We would particularly welcome evidence on

a. how UK asset managers, and UK companies, expect the pressures on them to change with further internationalisation of equity investment;

b. whether recent or planned regulatory actions by authorities outside the UK, and particularly regulatory policy developments at EU level, will affect engagement between asset managers and the companies in which they invest, and the ability of companies to respond to that engagement.

How to submit your response

This call for evidence was published on 15th September 2011; the last date that responses can be received is 18th November 2011. We would prefer to receive submissions by email where possible but we will accept responses sent by post. Contact details for the review team are below:

kayreview@bis.gsi.gov.uk

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When responding, please state whether you are responding as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation represents by selecting the appropriate interest group on the response form and, where applicable, how the views of members were assembled. Please clearly state the name and contact details of the person to contact for any follow up discussions concerning your submission.

If you have questions about the review, please contact the review team by email or post using the addresses above. Alternatively you can contact the review team by telephone on **+44 (0)20 7215 5098**.

Additional Copies

You may make copies of this document and circulate it to other interested parties without seeking permission. Further printed copies of the document can be obtained from the review team at the contact details above. An electronic version can be found at www.bis.gov.uk/kay review. Versions of the document in Braille, other languages or audio-cassette are available on request.

Confidentiality & Data Protection

Information provided in response to this call for evidence, including personal information, will be held by the Department for Business, Innovation and Skills on behalf of Professor Kay. It may be subject to publication or release to other parties or to disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004). If you want information, including personal data that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.