



# Department for Business Innovation & Skills

**BUILDING A CULTURE OF  
LONG-TERM EQUITY INVESTMENT**

Implementation of the Kay  
Review: Progress Report

OCTOBER 2014



# Foreword



In commissioning Professor Kay's review of UK equity markets, the Government sought to address the longstanding concern that an excessive focus on short-term performance in equity investment markets was impeding the creation of sustainable value by British companies.

Professor Kay's analysis was as comprehensive as it has subsequently been influential, both here in the UK and internationally. His review set out a clear challenge to companies, investors and Government to bring about a shift in the culture of equity markets by rebuilding relationships of trust and confidence and aligning incentives in the investment chain.

This report sets out progress made in response to that challenge. It highlights steps taken by Government and market participants to implement Professor Kay's vision, in particular by encouraging effective shareholder engagement and stewardship; reforming corporate reporting to ensure information supports a dialogue between investors and companies about long-term strategy; setting minimum standards of behaviour and good practice needed to restore trust; and addressing misaligned incentives which can undermine that trust.

In concluding his review, Professor Kay warned that the task of reform he set out would be long and difficult. Good progress has been made, and many of the building blocks for are now in place for a genuine shift in the culture of equity markets. However we recognise that more needs to be done.

The report sets out how the Government is taking forward work in a number of areas to ensure the commitment to reform is sustained. In particular it includes our response to the Law Commission's review of fiduciary duties and our plans to build on research, commissioned in response to the Kay Review, to help investors better to focus on long-term performance. It also details a variety of reforms and further work planned by the various regulatory authorities which will further support this important agenda. Alongside this work we see good signs that both UK companies and investors share our commitment to culture change. If we are to ensure equity markets support long-term economic growth, it will be vital that they deliver on this commitment.

A handwritten signature in black ink, appearing to read "Vince Cable".

**Vince Cable**

Secretary of State, Department for Business, Innovation and Skills



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# 1. Executive Summary

## The Kay Review

1.1. The Kay Review published its final report in July 2012,<sup>1</sup> setting out a radical agenda for reform of UK equity markets to address misaligned incentives and to restore relationships of trust and confidence in the investment chain. It presented a series of high-level principles for equity markets to provide the foundations for a shift in the culture of investment to promote a longer-term outlook which would better enable UK companies to deliver sustainable long-term economic growth. It outlined directions for market practice and regulatory policy which followed from these principles, and made 17 specific recommendations for Government, regulatory authorities, and market participants.

## The Government's Response

- 1.2. The Government response, in November 2012,<sup>2</sup> welcomed the Kay Review and called for a sustained commitment to reform from both government and market participants to deliver against this agenda.
- 1.3. The Government response endorsed Professor Kay's principles for equity markets to which market practitioners, government and regulatory authorities should have regard. It set out a number of specific steps for Government to deliver against the Review's detailed recommendations. We signalled our support for Professor Kay's suggested good practice approach and challenged business representative groups and investment industry trade associations to use the Reviews' directions for market participants and the Good Practice Statements as a starting point to further develop good practice standards. We also committed to work with relevant regulatory authorities to explore further the Review's implications for regulatory policy.
- 1.4. The Government committed to publishing an update on progress achieved by the Government, regulatory authorities and market participants, to deliver the Review's specific recommendations and to respond to its wider principles and directions. This report meets that commitment.

## Overview of Progress

- 1.5. Good progress has been made to implement the agenda set out in the Kay Review. The main body of this report summarises the main developments thematically in three parts. In each part of the report we refer to the specific recommendations made in the Kay Review, noting what steps the Government

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<sup>1</sup> The Kay Review of UK Equity Markets and Long-Term Decision Making, Final Report, July 2012: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf)

<sup>2</sup> Ensuring Equity Markets Support Long-Term Growth – The Government Response to the Kay Review, November 2012: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/253457/bis-12-1188-equity-markets-support-growth-response-to-kay-review.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253457/bis-12-1188-equity-markets-support-growth-response-to-kay-review.pdf)

has taken, the response from market practitioners, and relevant developments in the regulatory framework.

- 1.6. In Part A of the report, we outline the progress made in encouraging effective shareholder engagement and stewardship investing. In particular we note:
  - The Financial Reporting Council (FRC) published an **updated Stewardship Code in September 2012**, strengthening the emphasis on engagement on long-term company strategy, in line with the recommendation of the Kay Review.
  - Evidence suggests **encouraging progress in the volume and quality of stewardship and engagement, and on reporting on stewardship activity** – although more progress is needed.
  - Leading institutional investors have also delivered against Professor Kay's recommendation that they create an **Investor Forum** to improve the amount and effectiveness of collective engagement - a key recommendation of the Kay Review.
  - More broadly, there has been a positive response from both companies and investors in terms of developing good practice on stewardship and engagement, and we particularly highlight a new **Stewardship Disclosure Framework**, developed by the National Association of Pension Funds (NAPF) which encourages asset managers to clearly articulate their approaches to stewardship to their clients.
- 1.7. A number of Professor Kay's recommendations focused on improving the quality of reporting and dialogue in the investment chain to ensure that information meets the needs of those with long-term investment objectives. Part B of the report describes progress made against this goal. In particular we highlight:
  - The **Government's reforms to corporate narrative reporting** framework, introduced from October 2013, to make annual reports less burdensome, more relevant, and more focused on long-term company strategy, and evidence of a positive response from companies.
  - The FRC's new **guidance on narrative reporting** published in June 2014.
  - The removal of **mandatory quarterly reporting** requirements, in line with the recommendation of the Kay Review, following amendments to the EU Transparency Directive and changes to UK legislation. We expect the Financial Conduct Authority (FCA) to confirm the necessary changes to the Disclosure and Transparency Rules imminently.
  - **Independent research into metrics and models used to assess company and investment performance by long-term investors**, commissioned by Government in response to the Kay Review, and published alongside this report today.
- 1.8. Finally, Part C considers the progress made in building trust-based relationships and aligning incentives through the investment chain. In particular, we report:
  - The **Government's response to the Law Commission review into the fiduciary duties of investment intermediaries**. We welcome in particular its

conclusion that fiduciaries such as pension scheme trustees have a duty to consider any factors which are, or may be, financially material to the performance of an investment, including over the long-term. We also set out a response to the Law Commission's detailed recommendations directed at the Government departments, the FCA and the Pensions Regulator (TPR).

- The **Government's comprehensive reforms to the governance of company directors' remuneration** to boost transparency in reporting and strengthen accountability to shareholders through a binding vote, which support Professor Kay's recommendation on company directors remuneration. We note in particular **progress made by investors on engagement with companies to set clear expectations on executive pay and evidence of companies' response**, which shows signs of restraint in terms of levels of remuneration and moves towards longer-term pay structures.
- The Government's response to Professor Kay's recommendation to keep the scale and effectiveness of merger activity of and by UK companies under review. We highlight in particular the **Takeover Panel's recent proposed changes to the Takeover Code**, which would distinguish between voluntary statements of commitment ("post-offer undertakings") and required statements of intention, and allow the Panel to intervene quickly to take enforcement action if it is satisfied there is a reasonable likelihood that a company will breach its commitment. The Government welcomes these proposed changes, and the Panel's assurances that the new arrangements will provide an effective means of supervising compliance, and of ensuring companies' undertakings are met.
- The **Government's reforms to the governance of contract-based workplace pension schemes**, including new minimum quality standards and the new requirement on contract-based pension providers to establish Independent Governance Committees to protect members best interests.
- A number of relevant **developments in the FCA's regulation of investment and asset management firms** in support of, including with respect to the management of conflicts of interest, the management of client assets, and transparency on costs and charges in the investment chain.
- **Updates to the Pension's Regulator's regulatory strategy and Codes of Practice** for both defined contribution and defined benefit pension schemes, which address regulatory drivers for an excessive focus on short-term risks and performance, and reflect the Regulator's new statutory objective to promote sustainable growth.
- The development of various **industry good practice and regulatory measures to improve transparency of costs and charges in the investment chain**. These represent good progress against the Kay Review recommendations for improved disclosure by asset managers, and with respect to the income and associated costs from stock lending.
- The agreement of a new UCITS (Undertakings in Collective Investments in Transferable Securities) Directive which includes provisions to better align the **remuneration of asset managers** with the interests of their clients.

- The FRC's latest revisions to the **Corporate Governance Code**, which reflect our reforms to remuneration reporting and seek to encourage more genuinely long-term remuneration structures.

### **Next steps:**

1.9. The Government believes that the progress set out in this report represents a significant contribution to the necessary shift in the culture of equity markets advocated by Professor Kay. However, we acknowledge that further progress is needed, and set out in the report a number of important areas on which market participants, government, and regulatory authorities are now focused. We highlight in particular next steps in a number of areas below:

- The FRC commitment to focus on **encouraging and monitoring signatories to the Stewardship Code** to ensure they are delivering on the commitment they have given. We hope that this work, together with the ongoing development of the NAPF's Stewardship Disclosure Framework, will promote more meaningful commitments to the Stewardship Code and facilitate clear choices on stewardship for pension funds and other investors.
- The Government and regulatory authorities will now take forward work in a number of areas in response to the recommendations of the Law Commission review of fiduciary duties. In particular this will **ensure that the Law Commission's central findings with respect to consideration of long-term factors in investment decisions will be effectively embedded in regulatory guidance** for trustees of trust-based pension schemes and for Independent Governance Committees operated by the providers of contract-based pension schemes.
- The Government will consult, in response to the recommendations of the Law Commission Review, on amending the Occupational Pension Scheme (Investment) Regulations, including to require trustees of **trust-based pension schemes to state the scheme's policy (if any) on stewardship** in the scheme's Statement of Investment Principles, with reference to the Stewardship Code. This will mirror the current rules for contract-based schemes.
- The Government will continue to support **the development of the Investor Forum** which we believe has the potential to deliver a step change in effective collective engagement on the part of investors in UK companies, which the Professor Kay identified as a vital step in shifting the culture of equity markets to support long term corporate success.
- The Secretary of State for Business Innovation and Skills will convene **a roundtable in January 2015, to consult senior stakeholders from business and the investment industry on their views of progress to date on shareholder engagement and stewardship, and on what further steps the Government, FRC and industry can take to encourage better engagement and long-term stewardship investing.** This will take forward our commitment following the Kay Review to review industry progress on shareholder engagement.
- The Department for Business Innovation and Skills will also seek to build on the analysis and suggestions presented in the research paper published

today on the **use of metrics and models in the investment chain**. We will convene a number of focused roundtable discussions to agree practical outcomes at a detailed level, with a view to deciding where additional guidance on good practice and/or regulatory interventions may be appropriate. We expect to hold the first of these before the end of the year, and aim to involve the researchers, the Expert Panel, and a variety of representatives of companies, asset managers and investors, and other intermediaries, as well as the relevant regulators.

- The **FCA is conducting a broad review of competition issues in the wholesale financial markets** to identify any areas that might merit further investigation through an in-depth market study. This aims to highlight areas where competition may be weak or not be working properly in wholesale securities and investment markets, potentially resulting in sub-optimal outcomes for investment clients. The review includes consideration of markets for asset management and investment consultancy.
- The Government remains focused on **ensuring that executive remuneration is aligned with long-term sustainable company performance**, and is keeping policy on company directors' remuneration under review. We are currently monitoring the impact of the Government reforms to the governance of directors' remuneration in the context of the 2014 reporting and AGM season. **We will publish the key findings from this work and any policy conclusions we draw from it shortly.**
- The Government is also committed to further **work to consider whether our system for holdings of securities electronically works effectively and efficiently for both investors and issuers**. This work will continue to explore (in discussion with the FCA and key stakeholders) **the most cost effective means for individual investors to hold shares directly on an electronic register**, should they wish to do so, as recommended by the Kay Review. It will form part of the implementation of the EU Central Securities Depositories Regulation (CSDR) which requires dematerialisation (i.e. the abolition of paper certificates) for transferable securities admitted to trading venues, including shares in quoted companies, by 2023 for newly issued securities, and by 2025 for all securities.

1.10. This further work demonstrates the Government's continued focus on ensuring that public equity markets support the long-term success of UK companies which is vital to future economic prosperity.

## 2. Progress Report

### Part A: Encouraging Effective Engagement and Stewardship

- 2.1. One of the central objectives of the Kay Review proposals was to improve the quality of engagement by investors with companies, emphasising and broadening the existing concept of Stewardship. Professor Kay highlighted that company directors, asset managers and asset “holders” should see themselves as stewards of assets on behalf of end investors, and stressed the importance of trust-based relationships as the basis for dialogue through the investment chain. He emphasised that asset managers in particular should have greater involvement with the companies in which they invest. This part of the report focuses on progress made on encouraging effective engagement and stewardship – with reference to Professor Kay’s specific recommendations in this area.

#### Development of the Stewardship Code:

- 2.2. The Kay Review recommended specifically that: “*the Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance*”.  
**(Recommendation 1).**
- 2.3. The FRC published a revised edition of the Stewardship Code in September 2012.<sup>3</sup> In line with Professor Kay’s recommendation, this new edition of the Code clarified the aim and definition of stewardship, making clear that good stewardship by institutional investors goes beyond simply monitoring companies’ compliance with the letter of the Corporate Governance Code to encompass a focus by investors on companies’ long-term strategy to deliver sustainable returns, and considered engagement with the boards of companies to that end.
- 2.4. The FRC regularly reviews the implementation and impact of its Codes and since 2011 has published an annual report on Developments in Corporate Governance.<sup>4</sup> It has considered whether further changes to the Stewardship Code are needed to reflect the relevant Kay Review recommendations, principles and Good Practice Statements in this context.
- 2.5. The Stewardship Code now has almost 300 signatories who collectively manage a large portion of the assets under management in the UK, and indeed a significant portion of UK listed equities. The FRC therefore concludes that the current signatories to the Code have the potential to provide a critical mass of investors willing to act as engaged owners of UK companies and focusing on companies’ capacity to generate sustainable long-term returns.

<sup>3</sup> The Stewardship Code September 2012: <http://frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx>

<sup>4</sup> FRC, Developments in Corporate Governance 2013: The impact and implementation of the UK Corporate Governance and Stewardship Codes, December 2013: <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-2013.pdf>

- 2.6. The latest Investment Management Association (IMA) annual report on signatories' adherence to the Stewardship Code, published in May 2014 suggests real progress towards this objective, with welcome changes in approach on the part of Code signatories.<sup>5</sup> The report is based on responses to a survey developed with the FRC from 82 Asset Managers (collectively managing £702 billion of UK equities), 27 Asset Owners (holding £38 billion of UK equities) and five Service Providers. The report concludes in summary that:
- In the year to 30 September 2013, the resource that respondents allocate to engagement has increased markedly, with an increase of approximately 30 per cent based on headcount.
  - Stewardship is explicitly referred to in the 83 per cent of mandates awarded to asset managers in the year to 30 September 2013, up from 71 per cent in 2012.
  - For 44 per cent of asset managers, stewardship is referred to in all clients' mandates, compared to 30 per cent in 2012.
  - Business strategy, board leadership and board composition are the three issues respondents consider to be most important for engagement, followed by board remuneration.
  - More respondents gave advance notice when they intend to abstain or vote against a resolution (47 per cent in 2013, up from 35 per cent in 2012).
  - Nearly all respondents report to their clients or beneficiaries on their stewardship activities, with voting records disclosed publicly by 66 per cent of respondents.
- 2.7. However, despite these encouraging signs, the FRC considers that improvements in the volume and quality of stewardship and engagement have not been felt consistently across the listed sector. While the FRC Developments in Corporate Governance 2013 report notes encouraging progress in terms of the amount of engagement between large companies and their major shareholders, and in the breadth of issues on which this engagement is focused, it also expresses concern about levels of engagement in mid-market companies. Similarly, while it identifies improvements in the reporting on stewardship in many cases, it acknowledges that the quality of reporting by Stewardship Code signatories remains variable. Overall the FRC notes that the Code is in its infancy, and more progress is needed in terms of behavioural change on the part of investors.
- 2.8. Accordingly, while the FRC has not ruled out further changes to the Stewardship Code, its recent and current focus is on the Code's implementation. It has made clear that its main priority is to encourage and assist signatories to the Code to deliver on the commitment they have given, and to monitor whether they are doing so. The FRC is, therefore, considering options for enhancing the scrutiny of adherence to the Code. This is likely to include mechanisms for ensuring that statements are complete and up to date, with consideration given to sanctions if they are not.

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<sup>5</sup> IMA Survey: Adherence to the Stewardship Code at 30 September 2013, published May 2014, available at: <http://www.investmentuk.org/research/stewardship-survey/>

- 2.9. We expect the FRC to publish a further report on Developments in Corporate Governance and Stewardship in December 2014, and to set out their intentions for this work in more detail in the first half of 2015.

### **Industry Good Practice on Stewardship:**

- 2.10. The two objectives of the Stewardship Code are to increase the quality and quantity of engagement between company boards and investors, and to improve accountability and transparency down the investment chain to the real owners of those companies. These are not objectives that can be achieved through the Code alone, and the FRC has made clear that it will continue to work closely with market participants, other regulators and the Government to deliver them.
- 2.11. The Kay Review recommended that *company directors, asset managers and asset holders should adopt Good Practice Statements* (presented by the review) *aimed at promoting stewardship and long-term decision making* (**Recommendation 2**). In response, the Government acknowledged the importance of industry-led good practice in achieving the necessary shift in the culture of equity markets, and challenged business representative groups and investment industry trade associations to review these statements as a starting point to further develop good practice standards.
- 2.12. The Government notes the positive response to this challenge. The Government particularly welcomes the development of a Stewardship Disclosure Framework by the NAPF, in response to a recommendation from the report of the 2020 Investor Stewardship Working Group report: Improving the Quality of Investor Stewardship.<sup>6</sup> The Framework was initially published in October 2013,<sup>7</sup> and aims to provide greater transparency around the stewardship policies and activities of those asset managers who are signatories to the UK Stewardship Code, by encouraging them to report to pension funds and other clients the extent to which they fulfil a number of different categories of good practice in stewardship.
- 2.13. The NAPF wrote to all asset manager signatories to the Stewardship Code to ask them to complete the Disclosure Framework. We understand that over 60 asset managers have now responded, including a significant number of the largest firms in terms of assets under management. A list of those who have disclosed and those who are yet to do so is provided on the NAPF website with links to the disclosures made.<sup>8</sup>
- 2.14. The NAPF announced on 22 October that it intends to build on this initiative by organising a rolling programme of meetings, similar to company AGMs, which will provide an opportunity for pension funds to collectively question senior

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<sup>6</sup> 2020 Investor Stewardship Working Group report: Improving the Quality of Investor Stewardship, March 2012, available at Tomorrow's company website: <http://tomorrowscompany.com/2020-stewardship-improving-the-quality-of-investor-stewardship-the-report-3>

<sup>7</sup> NAPF Stewardship Disclosure Framework, October 2013, available at: <http://www.napf.co.uk/PolicyandResearch/Corporate-Governance/Stewardship/Stewardship-disclosure-framework.aspx>

<sup>8</sup> Ibid.

representatives of asset management firms directly on their stewardship activities – with reference to the Stewardship Disclosure Framework.

- 2.15. The Government believes the Stewardship Disclosure Framework provides a useful tool to facilitate dialogue between asset managers and their clients on stewardship activity. We encourage asset managers who have not done so to consider disclosing against the framework. We also hope pension funds will take the opportunity presented by the planned meetings to press their asset managers to deliver high standards of stewardship in the interests of beneficiaries.
- 2.16. Prior to developing the Stewardship Disclosure Framework, the NAPF published a Stewardship Policy, in November 2012, designed to encourage and enable pension schemes to understand and fulfill their responsibilities as investors and to sign-up to the Stewardship Code.<sup>9</sup> It suggests they do this by including a section on ‘stewardship’ within the fund’s Statement of Investment Principles, including stewardship criteria in manager searches, and incorporate monitoring of stewardship activities into manager reviews. The policy includes a series of principles for stewardship best practice which reflect the Kay Good Practice Statements, Guidance on application of the Stewardship Code, and a questionnaire designed to help pension schemes to discharge their commitment to the Code.
- 2.17. The NAPF has supported its Stewardship Policy with an updated guide to its members on Responsible Investment<sup>10</sup> and by providing a short guide for pension scheme trustees on “Quizzing Fund Managers”, accompanied by a monthly bulletin of topical questions, to aid trustees in asking the fund managers about their stewardship activity.<sup>11</sup>
- 2.18. The Government also welcomes a number of other initiatives on the part of business groups and investment industry trades bodies which contribute to the development of good practice on improving the quality of engagement between companies and investors and enabling stewardship on the part of asset managers and asset holders. We highlight in particular:
- The Institute of Chartered Secretaries and Administrators (ICSA) published guidance in March 2013, entitled “Enhancing Stewardship Dialogue”,<sup>12</sup> aims to improve the quality of engagement between investors and companies. This was produced by a steering group which involved the IMA, and

<sup>9</sup> NAPF Stewardship Policy 2012:

[http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0272\\_Stewardship\\_policy\\_NAPF\\_2012.ashx](http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0272_Stewardship_policy_NAPF_2012.ashx)

<sup>10</sup> NAPF Responsible Investment Guide 2013:

[http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0308\\_NAPF\\_Responsible\\_Investment\\_guide\\_2013.aspx](http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0308_NAPF_Responsible_Investment_guide_2013.aspx)

<sup>11</sup> NAPF website: Stewardship Central: <http://www.napf.co.uk/PolicyandResearch/Corporate-Governance/Stewardship.aspx>

<sup>12</sup> ICSA Guidance, Enhancing Stewardship Dialogue, March 2013, available at:  
<https://www.icsa.org.uk/products-and-services/knowledge-and-guidance/resources/engagement-with-investors>

representatives of both institutional investors and companies, and also followed recommendations from the report of the 2020 Investor Stewardship Working Group report: Improving the Quality of Investor Stewardship.<sup>13</sup> The guidance reflects the relevant aspects of the Kay Good Practice Statements, and provides practical suggestions for companies and investors focused on:

- creating a more meaningful dialogue between companies and institutional investors on strategy and long-term performance outside of the traditional results season;
  - making meetings between companies and institutional investors more productive; and
  - improving the feedback process, in both directions, between companies and institutional investors on the quality of meetings, and learning from this experience.
- The Quoted Companies Alliance (QCA) has updated its Corporate Governance Code for Small and Mid-Size Quoted Companies which adopts key elements of the FRC's Corporate Governance Code and other relevant guidance and applies these to the needs and circumstances of small and mid-size quoted companies. It includes provisions to encourage positive engagement between companies and their shareholders.<sup>14</sup>
  - The Association of Investment Companies (AIC) has updated its Corporate Governance Code for Investment Companies<sup>15</sup> which seeks to provide its members with a framework of best practice to allow them to apply the UK Corporate Governance Code. In preparing the new Code the AIC has considered the relevant aspects of the good practice statements set out in the Kay Review for both company directors and asset holders.
  - The Association of British Insurers (ABI) published a paper in July 2013 on Improving Corporate Governance and Shareholder Engagement, which renewed their members' commitment to engagement and stewardship, and signaled support for the development of a "Stewardship Mandate" to be included as part of investment agreements between asset holders and asset managers, as well as for the inclusion of statements about Stewardship to be incorporated into pension schemes' Statements of Investment Principles.<sup>16</sup>

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<sup>13</sup> 2020 Investor Stewardship Working Group report: Improving the Quality of Investor Stewardship, March 2012, available at Tomorrow's company website: <http://tomorrowscompany.com/2020-stewardship-improving-the-quality-of-investor-stewardship-the-report-3>

<sup>14</sup> Quoted Companies Alliance (QCA) Corporate Governance Code for Small and Mid-Size Quoted Companies 2013, available at: <http://www.theqca.com/shop/guides/86557/corporate-governance-code-for-small-and-midsize-quoted-companies-2013-downloadable-pdf.thtml> NB: The Code is endorsed by the FRC.

<sup>15</sup> The Association of Investment Companies (AIC) Code of Corporate Governance, available at: <http://www.theaic.co.uk/sites/default/files/hidden-files/AICCodeofCorporateGovernanceFeb2013.pdf>

<sup>16</sup> ABI Paper: Improving Corporate Governance and Shareholder Engagement, July 2013, available at: <https://www.abi.org.uk/~media/Files/Documents/Publications/Public/Migrated/Investment%20and%20Corporate%20governance/Improving%20Corporate%20Governance%20and%20Shareholder%20Engagement.pdf>

- The Investment Management Association has launched work to develop a Statement of Principles for its members accompanied by operational guidance. Its stated intention is to promote good practice among investment managers with particular focus on fulfilling responsibilities to clients. We hope this will provide a further opportunity for the industry to embed minimum standards for asset managers.

### The Investor Forum and Collective Engagement:

- 2.19. The Kay Review recommended that *an investors' forum should be established to facilitate collective engagement by investors in UK companies* (**Recommendation 3**), as part of a broader focus on promoting stewardship investment.
- 2.20. The Government supported this recommendation and welcomed the response from institutional investors, a number of whom set up a Collective Engagement Working Group in 2013, with the support of the IMA, the ABI, and the NAPF. The Working Group's report in December 2013<sup>17</sup> considered the challenges involved in improving the amount and effectiveness of collective engagement, and recommended that an Investor Forum should be created. It tasked an industry-led implementation team to achieve this objective in the first half of 2014.
- 2.21. The Government has played a support and challenge role in this process, but has made clear throughout that if the Investor Forum were to be successful, and achieve buy-in from a broad range of equity investors, it was important that investors themselves led the process: designing the forum to meet their needs and to build on existing approaches to shareholder engagement.
- 2.22. We are pleased to report that an Investor Forum was duly established in July 2014, along the lines envisaged by Professor Kay. Launched with the support of the major trade associations, it will operate as an independently governed organisation, with its own Chairman, Simon Fraser<sup>18</sup>, and Executive Director, Andy Griffiths.<sup>19</sup>
- 2.23. The Investor Forum has set clear objectives to improve long-term returns from investment in companies. In its founding statement it described these as:
1. Promoting the value of long-term approaches to investment to match the long-term objectives of the individual savers who are ultimately the beneficiaries of the long-term returns delivered by investment management
  2. Promoting cultural change throughout the investment chain – encompassing asset owners and their advisers, as well as asset managers and investee companies.

<sup>17</sup> Report of Collective Engagement Working Group December 2013, available at:  
<http://www.investmentuk.org/assets/files/press/2013/20131203-cewginvestorforum.pdf>

<sup>18</sup> Simon Fraser was formerly Chief Investment Officer of Fidelity Worldwide Investment. He is currently Chairman of Foreign & Colonial Investment Trust plc and a Non-Executive Director of Ashmore Group plc. Simon is also a former Non-Executive Director of Barclays PLC.

<sup>19</sup> Andy Griffiths has twenty years' experience as a top rated Research Analyst and investment professional at Capital Group, where he had specific responsibilities for investments in European banks and international equities. He is currently a Senior Advisor to Corsair Capital.

3. Forming Engagement Groups to drive constructive change when there is a critical mass of support among Forum participants that a company is failing in some way that might compromise long-term returns.
- 2.24. The Government particularly welcomes the clear statement from the Investor Forum that participation will be open to all investors who have an interest in UK companies, whether asset managers or asset owners, and whether based in the UK or overseas. The globalised nature of equity markets means that many international institutions, including overseas pension funds and sovereign wealth funds, have significant long-term shareholdings in many UK public companies. The Government understands that a number of these investors have indicated a welcome interest in the Investor Forum, alongside widespread support from both UK-based institutional investors and companies. We would encourage others to follow suit.
- 2.25. The Investor Forum met for the first time in September 2014 and is now in the process of finalising its constitution and operating model, which will involve a governing Board supported by a number of stakeholder groups. We understand that the Forum will make a further announcement, timed to coincide with this report, setting more details and the progress it has made in building support from investment managers and asset owners. We understand that the Forum is now operational and we look forward to it making a genuine impact.
- 2.26. Alongside the Investor Forum, the Government also welcomes the merger of the ABI's Investment Affairs division and the IMA, on 30 June 2014. We believe the new, enlarged IMA (to be renamed The Investment Association in January 2015) will be well placed to facilitate collective engagement across a broad range of institutional investors. In particular we note that the new organisation will assume responsibility for the "investor exchange" mechanism set up by the ABI in 2014, which enables any significant shareholder to raise a concern on a particular UK listed company with other shareholders.

### **Consulting Investors on Board Appointments:**

- 2.27. The establishment of the Investor Forum may provide a means for *companies to consult their major long-term investors over major board appointments* as recommended by the Kay Review (**Recommendation 5**).
- 2.28. In response to this recommendation, the Government set out the view that effective consultation of shareholders on major board appointments was a matter on which company directors should be encouraged to develop good practice. We therefore included the recommendation in the Good Practice Statement for Company Directors published as part of that response. We noted that many companies already consult shareholders on board appointments in the context of wider engagement activity and that the existing provisions of the Corporate Governance Code relating to the effectiveness of companies' boards and their relations with shareholders are consistent with such consultation.<sup>20</sup> We asked the FRC to consider whether there is a need for more detailed or explicit guidance

<sup>20</sup> The UK Corporate Governance Code, FRC website: <http://frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx>

on this practice in this context, as part of their ongoing work on Corporate Governance.

- 2.29. In the course of 2013, the FRC held a number of discussions on effective board evaluation with companies, investors and board evaluators. Their conclusion was that there was a particular need to focus on improvements in board succession planning. Accordingly the FRC will undertake a research project on board succession planning, beginning before the end of 2014.
- 2.30. This project will have a broad scope, considering succession planning as well as board nomination committee processes. The FRC intends to produce a discussion paper to inform the development of the project, which will call for evidence on various themes, including: board evaluation; investor engagement; strategic/business planning for future board appointments; the executive “pipeline” and talent management; diversity; the recruitment of non-executive directors; and the role of nominations committees. The FRC expects the project will involve engagement with a wide range of stakeholders.
- 2.31. The FRC’s stated aim for the project is to identify and spread good practice in succession planning and on the effectiveness of board nomination committees. We expect that this will include consideration, as part of the investor engagement theme, of how companies can effectively consult shareholders on board appointments, in line with the Kay Review recommendation. At this stage there can of course be no presumption that this work will necessarily lead to further amendments to the UK Corporate Governance Code, although we expect the FRC will consider this and other possible options, including the need for separate guidance in this area.
- 2.32. In our response to the BIS Select Committee Report on implementation of the Kay Review,<sup>21</sup> we noted the Committee’s concerns about the tension which can arise between consultation of the kind envisaged by the Kay Review, and the need for confidentially and timely disclosure of market sensitive information on the part of companies. The Government has asked the FRC to further consider this issue specifically in the course of their project.

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<sup>21</sup> Government response to the BIS Select Committee Report on implementation of the Kay Review, November 2013, available at: <http://www.parliament.uk/business/committees/committees-a-z/commons-select/business-innovation-and-skills/inquiries/parliament-2010/the-kay-review/>

## Part B: Ensuring information meets long-term investors needs

2.33. The Kay Review highlighted the importance of information in investment decisions, recommending that “noise” – the reporting of irrelevant data - should be reduced and reporting of performance should instead be clear, relevant, timely, related closely to the needs of users and directed towards the creation of long-term value. He called for more dialogue between companies, asset managers and investors about the information they need to make good decisions. This part of the report focuses on progress made in the context of Professor Kay’s specific recommendations in this area.

### Removal of Mandatory Quarterly Reporting:

2.34. Professor Kay recommended *that mandatory quarterly reporting obligations on quoted companies in the form of Interim Management Statements (IMS) should be removed* (**Recommendation 11**).

2.35. The Government agreed with Professor Kay’s recommendation. Rigid quarterly reporting requirements can promote an excessively short-term focus by companies, investors and market intermediaries and impose unnecessary regulatory burdens on companies, without providing useful or meaningful information for investors. We therefore strongly supported the proposal brought forward by the European Commission to amend the EU Transparency Directive to remove mandatory requirements on companies whose shares are admitted to trading on a regulated market to produce interim management statements on a quarterly basis.

2.36. The Amending Directive was formally adopted in June 2013 and came into force in November 2013.<sup>22</sup> The Government signalled its intention to implement the relevant sections of the directive as soon as it was practical to do so. The necessary changes to UK legislation were duly made in May 2014,<sup>23</sup> and the FCA published a consultation document in July 2014,<sup>24</sup> outlining the proposed changes to the Disclosure and Transparency Rules in their handbook. We expect the subsequent FCA policy statement to be published in November 2014, subject to approval by the FCA Board.

### Encouraging high quality narrative reporting:

2.37. The Kay Review recommended that “*high quality, succinct narrative reporting should be strongly encouraged*” (**Recommendation 12**). Specifically, Professor Kay observed that:

*“Good quality narrative reporting can put the financial results in context, highlight important factors and communicate strategy and risks to investors in an understandable, engaging and concise format. Conversely, poor quality reporting*

<sup>22</sup> Directive 2013/50/EU: <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32013L0050>

<sup>23</sup> The Financial Services and Markets Act 2000 (Transparency) Regulations 2014: <http://www.legislation.gov.uk/uksi/2014/1261/contents/made>

<sup>24</sup> FCA, CP14/12 Removing the Transparency Directive’s requirement to publish interim management statements, available at: <http://www.fca.org.uk/news/cp14-12>

*can obscure key information in a morass of superfluous detail and marketing speak, lengthening reports and confusing investors. It is therefore important that companies and investors communicate with each other to raise standards and continuously improve the quality of reporting to the standards of the best.”*

- 2.38. The Government supported this recommendation, which was strongly aligned with an existing policy commitment to review and reform the structure and approach to companies' narrative reporting. We published proposals and draft regulations to introduce a new format for companies reporting in October 2012.<sup>25</sup>
- 2.39. The new regulations came into force on 1 October 2013.<sup>26</sup> They removed some disclosure requirements altogether, and require that all companies, with the exception of small companies, produce a separate strategic report as part of a restructured annual report, presenting key information about the company's strategy and business model, and insights into the challenges and opportunities for the company in the future. In line with the recommendations of the Kay Review, our aim was to make reporting simpler, clearer and more relevant to investors' understanding of the business, as a catalyst for more effective engagement and dialogue between companies and shareholders on the creation of sustainable long-term value.
- 2.40. There is good evidence that companies have responded positively to the reforms. A recent research report from Blacksun plc analysing trends in the 2013 annual reports of FTSE 100 companies, finds that there has been a significant improvement in the key areas addressed by the regulations.<sup>27</sup> The report highlights in particular that:
- 97% of companies are now providing a discussion of strategy – with 88% of companies defining and addressing specific strategic objectives against which they can be held to account;
  - 95% of companies are providing a detailed discussion of their business model;
  - 94% of companies discuss clear business objectives in their reporting, with 86% focusing to some extent on long-term objectives; and
  - 83% of companies provide either a link from their identified key performance indicators to the overall strategy or to specific strategic objectives.
- 2.41. In support of the reforms, the FRC has developed Guidance on the Strategic Report, which it published in June 2014.<sup>28</sup> The guidance outlines the content of the strategic report as required by the new regulations, and includes communication principles that emphasise the qualities of good financial reporting. It encourages companies to focus on the application of materiality to

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<sup>25</sup> The Future of Narrative Reporting, BIS website: <http://www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation?cat=closedwithresponse>

<sup>26</sup> The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013: <http://www.legislation.gov.uk/uksi/2013/1970/contents/made>

<sup>27</sup> BlackSun plc: The Complete 100 – Making connections – Analysis of the FTSE100 2013 corporate reporting trends, available at: <http://www.blacksunplc.com/corporate/research/index.jsp>

<sup>28</sup> FRC Guidance on the Strategic Report available at: <https://frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/Ongoing-projects/Narrative-Reporting.aspx>

disclosures and to be innovative in the structure of information to improve the clarity and concision with which information is presented. The guidance forms part of a wider “Clear & Concise” initiative from the FRC which aims to promote good practice in corporate reporting, with the focus on communication of information in a way which is relevant to investors.<sup>29</sup>

- 2.42. The EU adopted a new directive on 29 September, which seeks to improve the quality and quantity of non-financial disclosure by the largest companies across Europe.<sup>30</sup> The UK has been broadly supportive of this initiative and through negotiations has ensured that the directive enables useful disclosure while minimising unnecessary regulatory burdens. The directive broadly mirrors the UK’s reforms to narrative reporting structure, and requires that companies with more than 500 employees disclose information in a number of areas where this is necessary for an understanding of the business.
- 2.43. Specifically, companies must provide a description of their business model, and must publish (on a comply or explain basis) their policies on environmental, social and employment matters, diversity, respect for human rights, and bribery matters. Included in this disclosure should be an assessment of the how the company’s operations may impact on these matters, the principal risks related to them and the company’s approach to managing these risks.
- 2.44. EU Member States have two years to transpose the Directive into domestic legislation. The Government will be consulting later this year on its plans for implementation of those aspects of the Directive which go beyond the existing UK requirements. Once implementation is completed, the FRC will consider whether any updates to the Guidance on the Strategic Report are required to reflect any changes in UK law.
- 2.45. The Government has in any case committed to keep this policy area under review, and to complete a post implementation review on the UK regulations in due course, in accordance with good practice.

### **Metrics and models used to assess company and investment performance:**

- 2.46. The Kay Review recommended that the Government *commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations for long-term investors* (**Recommendation 15**). The Government welcomed this suggestion, but, given the technical nature and broad scope of the issues involved, decided to progress the recommendation by commissioning a research project in this area.
- 2.47. We are pleased to be publishing the findings of the research alongside this Progress Report. The research has been conducted jointly by London Economics and Dr Paul Cox, of the University of Birmingham Centre for

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<sup>29</sup> More information on the FRC’s Clear and Concise initiative is available at:  
<https://www.frc.org.uk/Our-Work/Headline-projects/Clear-Concise.aspx>

<sup>30</sup> See European Commission statement of 29 September 2014: [http://europa.eu/rapid/press-release\\_STATEMENT-14-291\\_en.htm](http://europa.eu/rapid/press-release_STATEMENT-14-291_en.htm)

Household Assets and Saving Management. It was supported by an Expert Steering Panel of academics and market practitioners, who kindly volunteered their time to help shape the research and monitor its progress.<sup>31</sup>

- 2.48. The Kay Review found that the growth of intermediation and principal-agent relationships in the investment chain have led to an increased reliance on metrics and models to measure performance of companies and investment portfolios. Professor Kay argued that these measurements may be inherently unsuitable for investors with long-term investment horizons, and suggested that the presence of misaligned incentives can lead to intermediaries promoting the use of particular metrics or models which prompt investment decisions in line with their interests rather than those of end investors. Kay instead recommended that metrics and models used in equity investment should give information relevant to the creation of long-term value in companies and good risk-adjusted long-term returns to savers.
- 2.49. Taking this analysis as its starting point, the research focused on:
- the relationships between asset holders and asset managers, and the use of metrics and models in selecting and monitoring investment funds and their managers; and
  - the relationships between asset managers and company management, and the use of metrics and models to select and monitor equity investments and to assess underlying company performance.
- 2.50. The research was conducted using a series of semi-structured interviews with relevant market participants, including company CEOs, investor relations managers, sell-side analysts, buy-side researchers, asset managers, a variety of types of investor and a number of representative bodies. The results of these interviews were interpreted in the context of economic and finance theory, and existing empirical research.
- 2.51. The research initially focused on metrics and models in the narrow sense, seeking to identify the limitations of specific, largely quantitative measurement tools and approaches from the perspective of a long-term investor. However, this ultimately makes up a relatively small part of the Research Paper. The research concludes rather that the approaches taken to evaluating company and investment performance involve a broader range of both quantitative and qualitative assessments, and the concept of models and metrics is interpreted in this broader sense. From this perspective, the paper concludes that trust-based relationships between “principals” and “agents” in the investment chain, and informed dialogue and the exercise of judgement in the context of these relationships, are crucial to effective long-term investment decisions. This supports the conclusions of the Kay Review.

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<sup>31</sup> The Expert Steering Panel members were: Sarah Breeden, Head of Markets, Sectors and Interlinkages Division, The Bank of England; Professor Alexander Ljungqvist, Ira Rennert Chair of Finance and Entrepreneurship, Stern Business School, New York University; Anne Marden, Managing Director, JP Morgan Asset Management; Saker Nusseibeh, CEO and Head of Investment, Hermes Fund Managers; Anne Richards, Chief Investment Officer and Executive Director, Aberdeen Asset Management; Professor John Thanassoulis, Professor of Financial Economics, University of Warwick Business School; and Colin Wilson, Technical Director, Government Actuaries Department.

2.52. The Research Paper therefore makes a number of suggestions for useful metrics for long-term investment, but also identifies a number of examples of how effective dialogue between principles and agents can break down, and makes a number of broader suggestions about how these issues might be resolved through changes in practice on the part of companies and investors. We highlight in particular suggestions made in the following areas:

- **Improving dialogue between companies and investors about future earnings and dividends to reduce unwarranted short-term market reactions.** The research finds that earnings guidance tends to be focused on point estimates of future performance which can become a target for company management, and a trigger for conclusions by investors as to whether a company is on track to deliver against its strategy. Company management is often therefore excessively focused on meetings earnings targets to avoid an impact on the company's share price in the short term. Similarly the research finds that company managers have the incentive to ensure dividend expectations are met in order to avoid a negative reaction from investors to a dividend cut which is interpreted as a signal that the company is underperforming. The research paper suggests that earnings guidance should avoid providing point estimates and instead communicate uncertainty around forecasts by reporting the path of earnings within a range using fan charts. Dividends expectations could then be explicitly linked to this expected range of performance outcomes. The research argues that this would dampen the potential for unwarranted reactions to differences between market expectations and realisations of earnings. It also suggests that companies and investors should have an annual meeting focused on forward looking company strategy only, separate from the reporting cycle and the AGM. These recommendations are directly relevant to the Kay Review recommendation that "*companies seek to disengage from the process of managing short-term earnings expectations and announcements*" (**Recommendation 6**), which the Government suggested companies should consider as a matter of good practice.
- **Improving the information companies receive from their investors about their reasons for changing equity holdings so as to reduce short-term reactions by company management.** The research finds that corporate managers may be taking actions in response to share ownership changes when they do not fully understand the reasons for these changes. In particular they may be conscious of the share price implications of such events, and interpret them as a market view of the fundamentals of the company, when in fact they have been motivated by other considerations such as changes to asset allocation in an investment fund or wider portfolio. Asset managers confirmed that this information is something that they rarely disclose to companies. The research therefore suggests that companies hold 'exit interviews' to communicate with shareholders that divest themselves of substantial holdings.
- **Embedding long-term objectives and stewardship into the processes used by investors when selecting and monitoring asset managers.** The

research suggests that institutional asset investors should use mandates and related correspondence with fund managers to articulate an investment time horizon more explicitly, and should explicitly integrate questions about the long-term within the procurement process. It also suggests fund managers should demonstrate how they have discharged stewardship through specific stewardship reporting. The research provides examples of questions to be used in the procurement process, and of appropriate stewardship. The Research paper suggests these might usefully complement or inform the Stewardship Code and related industry initiatives which seek to improve the focus on stewardship in the asset owner and fund manager relationship (including the Stewardship Disclosure Framework overseen by the NAPF).

- **Ensuring that reporting by asset managers to clients on investment performance takes appropriate account of the client's investment time horizons.** The research identifies a lack of clarity about the investment time horizon of organisations – and suggests that these should be more clearly articulated between asset managers and their clients to ensure alignment with client investment horizons. It provides examples of how average client investment maturity is calculated, and suggests metrics that might add balance to current investment reporting, provide a more meaningful comparison to client objectives, and prevent an unwarranted shortening of time horizons.
- **Addressing concerns that retail investors are prone to unwarranted fund turnover which is not in their long-term interest.** The research concludes this is driven both by an overreliance on fund ratings and past performance, and the approach used by advisers and fund managers, partly in response to regulatory requirements protecting retail investors from unsuitable investments and excessive risk. The research makes a number of practical suggestions for how these issues might be overcome. These suggestions are directly relevant to the Kay Review recommendation that "*Regulators should avoid the implicit or explicit prescription of specific models in valuation or risk assessment and instead encourage the exercise of informed judgement*" (**Recommendation 14**), which the Government asked relevant regulators to consider as a matter of regulatory good practice.

2.53. The research also suggests that the institutional asset owner sector, and the not-for-profit sector in particular, has a pivotal position in setting investment management contracts, and has significant scope to focus on returns from long-term patient investments. It identifies a willingness to share knowledge, expertise and combine resource for the improvement of decision making across the sector. It suggests that the sector more "professionalise", including through the creation of a professional institute, the establishment of a principles-based code of practice, and the development of education.

2.54. The research also addresses the role of executive remuneration. It finds that performance related remuneration structures linked to share price developments is a key factor in creating incentives for company executives to focus on short-term share price related metrics, with the resulting influence on the timescales of management decision making.

- 2.55. The Government welcomes the extremely useful analysis and suggestions presented in the Research Paper. Our objective is that it should provide the basis for a serious debate about the role of models and metrics in long-term investment strategies for different types of investor, with a view to deciding where additional guidance on good practice and/or regulatory interventions may be appropriate.
- 2.56. We will therefore convene a number of focused roundtable discussions to agree practical outcomes at a detailed level. We expect to hold the first of these before the end of the year, and aim to involve the researchers, the Expert Panel, and a variety of representatives of companies, asset managers and investors, and other intermediaries, as well as the relevant regulators.

## Part C: Building trust-based relationships and aligning incentives through the investment chain

2.57. Central to Professor Kay's analysis was the view that the problem of "short-termism" has arisen from the decline of trust-based relationships in the investment chain and the misalignment of incentives in an increasingly intermediated equity investment chain. He placed the restoration relationships of trust and confidence and efforts to better align incentives between market participants at the heart of his recommendations. This part of the report highlights progress made in response to these recommendations.

### Law Commission Review of Fiduciary Duties of Investment Intermediaries:

2.58. The Kay Review found there was significant uncertainty about the application of the legal concept of fiduciary duties and recommended that the Law Commission should be asked to review how it applies to investment to address uncertainties and misunderstandings on the part of trustees and their advisers (**Recommendation 9**).

2.59. In particular, Professor Kay sought to address the concerns that some investment intermediaries are interpreting their duties to their clients or to beneficiaries too narrowly to mean the duty to maximise short-term financial returns. He suggested that this may be the product of excessively risk-averse legal advice, and may lead an excessive focus on short-term performance metrics, with too little regard paid to factors affecting the investment in the long-term, including environmental, social and governance factors which may be relevant to company performance.

2.60. The Government accepted this recommendation, and asked the Law Commission to consider how fiduciary duties currently apply to investment intermediaries, and to clarify how far those who invest on behalf of others may take into account long-term factors, including social and environmental impacts and ethical standards.

2.61. The Law Commission published its final report on 1 July 2014, following a detailed consultation exercise.<sup>32</sup> The report examines the wider framework of law governing financial markets, including contractual agreements; the regulatory framework set by pension legislation, TPR and the FCA; and duties arising from "judge-made" law, which include duties of care and duties attached to the exercise of a power, as well as fiduciary duties.

2.62. It considers the question of long-term investment with particular reference to pensions, where liabilities will typically be incurred over a long period. It looks extensively at the duties of trustees of trust-based pension schemes, but also examines contract-based pensions, and the extent to which contract-based pension providers are under a duty to act in the best interests of members. In this

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<sup>32</sup> Law Commission Report on Fiduciary Duties of Investment Intermediaries, available at: [http://lawcommission.justice.gov.uk/areas/fiduciary\\_duties.htm](http://lawcommission.justice.gov.uk/areas/fiduciary_duties.htm)

context, the report signals its support for the Government's reforms to the governance of contract-based workplace pension schemes, including the new requirement on contract-based pension providers to establish Independent Governance Committees.

- 2.63. The Government welcomes the Law Commission's comprehensive report, and in particular welcomes its clear guidance that fiduciaries such as pension scheme trustees have a duty to consider any factors which are, or may be, financially material to the performance of an investment – including over the long-term. The report makes very clear that this should include taking into account environmental and social, and corporate governance factors and wider macroeconomic considerations, where trustees think these may be financially material.
- 2.64. We share the Law Commission's hope that this report will remove any remaining misconception that fiduciaries duties require trustees to focus on maximising short-term returns alone. We also welcome the Law Commission's conclusion that the law is sufficiently flexible to allow trustees to make investment decisions that are based on non-financial factors, provided they have good reason to think that scheme members share the concern, and there is no risk of significant financial detriment to the fund.
- 2.65. The Business Secretary has already written to a number of representative bodies in the pensions and investment industry welcoming the report and urging them to convey the Commission's clear guidance to their members. The Law Commission also published an executive summary, as well as a short guidance document outlining the main conclusions for trustees and other investment practitioners.
- 2.66. The report makes a number of specific recommendations to Government departments, and to the FCA and TPR, aimed at embedding its findings in relevant regulations and guidance, and addressing other issues identified in the course of the review. The Government's response to these, developed in consultation with the FCA and TPR, is set out in Table 1 overleaf.

**Table 1: The Government's Response to the Law Commission Report****Trust-Based Pension Schemes****Recommendation 1**

We recommend that TPR considers how the guidance we have set out can be given greater exposure and authority. In the short-term this could be through guidance in its trustee toolkit. In the longer term, we recommend that TPR include our guidance in one of its codes of practice.

The Government agrees with this recommendation. TPR has already:

- updated the Trustee Toolkit to reflect the Law Commission's findings; and
- signposted the Law Commission's Guidance Document for trustees (providing links from the TPR website and the Trustee Toolkit, as well as messaging to trustees via email).

In addition TPR will take forward this recommendation by updating its investment guidance to trustees. This will be done in the course of 2015, when TPR will review its Defined Contribution (DC) publications generally to reflect the introduction of new DC Quality Standards and Charge Controls, and supplement the Defined Benefit Code of Practice with more detailed guidance on investment strategy and integrated risk management.

**Recommendation 3**

We recommend that the Government should review three aspects of the Occupational Pension Schemes (Investment) Regulations 2005. These are:

- (1) the exemption of schemes with fewer than 100 members from the provisions of regulation 4;
- (2) the reference to "social, environmental or ethical considerations" in regulation 2(3)(b)(vii), to ensure that it accurately reflects the distinction between financial factors and non-financial factors; and
- (3) whether trustees should be required to state their policy (if any) on stewardship.

The Government accepts parts 2 and 3 of this recommendation and intends to consult at the earliest opportunity on two changes to the Occupational Pension Scheme (Investment) Regulations:

- to amend the reference to "social, environmental or ethical considerations" to ensure that it more clearly reflects the distinction between financial factors and non-financial factors; and
- to amend the regulations governing the Statement of Investment Principles to require trustees to state their policy (if any) on stewardship. This will mirror the current rules for contract based schemes. Schemes will be encouraged to state their stewardship policy with reference to the Stewardship Code.

It is important to stress in this context that the Government agrees with the Law Commission's conclusion that it would not be appropriate to attempt to codify the general law of fiduciary duties through legislation. As the Commission notes this would be a complex and lengthy process and would risk broader unintended consequences: in particular undermining the flexibility and adaptability inherent in common law. We note however that a number of stakeholders have suggested that it would be appropriate to include in the Occupational Pension Scheme (Investment) Regulations a specific statement clarifying that trustees should consider any factors which may be material to financial interests of scheme

	<p>members and beneficiaries, including long-term factors, and determine what weight should be attached to these factors in their investment decisions. The consultation exercise will provide an opportunity to evaluate stakeholder views on this suggestion.</p> <p>The Government will work closely with members of the pensions industry to ensure that any changes are implemented in a way that does not have any unintended consequences. Our intention is to ensure trustees are empowered to consider a range of factors when formulating their investment strategies in line with the Law Commission's findings.</p> <p>As regards part 1 of this recommendation, the Government has announced a new package of measures to strengthen the governance of DC workplace pension schemes, which will be introduced from April 2015. These will drive up standards in schemes of all sizes, including a requirement for trustees to report on how the design and performance of their default investment options are in members' interests. Given these new requirements, and the Government's agenda to keep additional burdens to a minimum, we do not think that removing the current exemption for schemes with less than 100 members from Regulation 4 will be an effective means to raise governance standards.</p>
<p><b>Recommendation 4</b></p> <p>We recommend that the Government should review two aspects of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. These are:</p> <ul style="list-style-type: none"> <li>(1) whether the Regulations should transpose article 18(1) of the IORP Directive; and</li> <li>(2) those aspects of regulation 9 which require investment managers to be appointed on a short-term basis and reviewed at least every three months.</li> </ul>	<p>The Government accepts the recommendation relating to Regulation 9 of the Local Government Pension Scheme (Investment and Management of Funds) Regulations and will include it as a recommended change when it consults in the near future on a range of changes to these regulations.</p> <p>The Department will also further consider the recommendation regarding the transposing of article 18(1) of the IORP Directive, in the context of ongoing negotiations at EU level relating to the proposed adoption of the IORP II.</p>

<b>Contract-Based Pension Schemes</b>	
<b>Recommendation 5</b> We recommend that Independent Governance Committees embedded within pension providers owe a statutory duty to scheme members to act, with reasonable care and skill, in members' interests. This duty should not be excludable by contract.	The Government believes that IGCs should have a clear duty to act solely in the interests of scheme members. The FCA published a consultation document on 6 August 2014, setting out its proposals for new rules governing Independent Governance Committees (IGCs) to be established by firms operating workplace personal pension schemes. The FCA is proposing a duty on IGCs to act in the interests of scheme members only, in line with the Law Commission's recommendation.
<b>Recommendation 6</b> We recommend that pension providers should be required to indemnify members of their Independent Governance Committees for any liabilities they incur in the course of their duties.	The FCA consultation document also explicitly seeks views on whether and to what extent indemnification of IGC members should be a requirement under FCA rules.  The Government notes that for contract-based schemes, the contract is between the pension provider and the member. The role of the IGC is to challenge the pension provider on issues relating to the value for money of workplace pension schemes. It is for the provider to take action in response to interventions made by the IGC.
<b>Recommendation 2</b> We recommend that the FCA consider whether Independent Governance Committees ( <i>embedded within contract-based pension providers</i> ) need further guidance in interpreting the interests of members in default funds.	The Government agrees with this recommendation, and will ask the FCA to consider, in light of responses to its consultation, whether IGCs require further guidance on interpreting the duty to act in the interests of members, and in particular on how they ensure that the firm gives appropriate consideration to the interests of members investing for the long-term, in the context of their duty to regularly review value for money offered by schemes.
<b>Recommendation 7</b> We recommend that, as part of its review of the default fund charge cap in April 2017, the Government should specifically consider whether the design of the cap has incentivised trading over long-term investment and, if so, what measures can be taken to reduce this effect.	The Government accepts this recommendation. The Government review of the default fund charge cap will include an assessment of any unintended consequences for pension fund members, including the risks identified in the Commission's report.

<b>Wider Reforms</b>	
<p><b>Recommendation 8</b> We recommend that stock lending fees should be considered alongside the review of the default fund charge cap in April 2017.</p>	<p>The Government welcomes the Law Commission's support for the Government's commitment to ensuring greater transparency of costs and charges, in the investment chain, including stock lending fees, and in particular for pension funds. We agree with the Law Commission's view that both trustees and Independent Governance Committees should be properly equipped to ensure that any stock lending fees represent value for money for scheme members given the services provided and the risks involved. We accept the recommendation that 2017 would be an appropriate timescale to review progress on these objectives.</p>
<p><b>Recommendation 9</b> We recommend that the Government should review the current operation of the system of intermediated shareholding, with a view to taking the lead in negotiating solutions at a European or international level.</p>	<p>The Government welcomes the Law Commission's analysis of the law of intermediated securities. The EU Central Securities Depositories Regulation (CSDR), which came into force in September, mandates dematerialisation (i.e. the abolition of paper certificates) for transferable securities admitted to trading venues, by 2023 for newly issued securities, and by 2025 for all securities. This requirement will apply to holdings of certificated shares.</p> <p>As part of the UK's implementation of dematerialisation, the Government (HM Treasury and BIS) will consider whether our system for holdings of dematerialised securities works effectively and efficiently for both investors and issuers. This will include exploring the most cost effective means for individual investors to hold shares directly on an electronic register, as recommended by the Kay Review. BIS is currently inviting tenders for research to inform the development of this work through its Research and Evaluation Procurement Framework. This research will seek to improve our understanding of both individual and institutional investors' experiences of intermediated share ownership, and whether reform would be desirable.</p> <p>Intermediated securities are the most common form of dematerialised securities, so it is essential that the laws related to these securities are clear and effective. Given the global nature of financial markets, the Government will also continue to take a lead in negotiating improvements to the substantive laws on intermediated securities at both a European and international level.</p> <p>CSDR also mandates for the first time that direct participants in Central Securities</p>

	<p>Depositories, such as CREST, must offer their clients a choice of both individually segregated ('designated') and omnibus ('pooled') accounts on reasonable commercial terms and disclose the protections afforded and costs of each level of segregation they offer. This is intended to provide greater choice and transparency in the system of intermediated shareholdings.</p>
<p><b>Additional Finding:</b>  The Law Commission Report notes the important role that investment consultants play in providing advice to pension schemes, the risk that they have an incentive to focus excessively on short-term returns, and the fact that they are not currently subject to FCA regulation in respect of the provision of generic advice.</p> <p>The report also notes that the extent to which such generic advice may be regulated is limited by the fact the EU Markets in Financial Instruments Directive regime (MIFID) which governs provision of advice, is a "maximum harmonisation" directive. It therefore stops short of an explicit recommendation in this area, but suggests the Government should monitor the risks in this market and consider action as necessary.</p>	<p>The Government and the FCA note the findings of the report in this area.</p> <p>The FCA recently launched a broad review of competition in wholesale markets in publishing a Call for Inputs in July 2014. This included a specific call for views and information about the role of investment consultants in relation to fund charges and governance, and the effectiveness of competition between investment consultants.</p>

## Minimum standards of behaviour for investment intermediaries:

- 2.67. The Kay Review identified misaligned incentives among investment intermediaries as a key driver of short-termism in the investment chain and recommended that *regulatory obligations in the chain should be raised to “fiduciary” standards* (**Recommendation 7**).
- 2.68. In response, the Government accepted the view that there should be common minimum standards of behaviour required of all investment intermediaries. However, having tasked the Law Commission to review the application of the concept of fiduciary duties, we elected not to describe these standards as ‘fiduciary’ – noting the potential for this term to be interpreted broadly by some and in a specific, narrow legal sense by others. We instead sought to define these standards of behaviour in the following principle:

*All participants in the equity investment chain should act:*

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

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

*These obligations should be independent of the classification of the client. They should not be contractually overridden.*

- 2.69. The Government asked the Financial Services Authority (FSA), and its successor organisation the FCA, to consider to what extent current regulatory rules in this area align with this principle, with particular reference to the issues raised in the Kay Report around conflicts of interest requirements and contractual mechanisms to limit the obligations of intermediaries, and to determine what action might be desirable. We also committed that the Government would have regard to this and other principles set out in the Kay Review in the development of relevant policy and regulation, and asked the relevant regulatory authorities to do the same. Progress has been made in response on a number of fronts:

- Professor Kay’s analysis raised the specific question of whether the FCA’s high-level principle that firms treat customers fairly was sufficient to ensure that they acted in the best interests of those clients. The FCA has considered this and made clear that the combination of requirements which apply to firms do collectively support the minimum standard set out above. Specifically they note that, in addition to the regulatory principles,<sup>33</sup> and a number of other high-level standards<sup>34</sup> (such as the requirement to have appropriate systems and controls in place) the FCA handbook contains

<sup>33</sup> FCA Handbook: Principles For Business: <http://fshandbook.info/FS/html/FCA/PRIN/2/1>

<sup>34</sup> FCA Handbook: High Level Standards <http://fshandbook.info/FS/html/FCA/D3>

specific Conduct of Business rules,<sup>35</sup> which require that among other things, “a firm must act honestly, fairly and professionally in accordance with the best interests of its client”, and “a firm must not... seek to exclude or restrict, or rely on any exclusion or restriction of, and duty or liability it may have to the client under the regulatory system”. These requirements apply to both retail and professional clients. While they do not apply to those clients categorised as “eligible counterparties”, all clients have the right to request a different client classification if they wish.

- The FCA, and its predecessor the FSA, have taken a number of important steps to ensure asset management firms have effective frameworks to identify and manage conflicts of interest. Specifically:
  - The FSA published the findings of a thematic review into asset managers' management of conflicts of interest in November 2012.<sup>36</sup> The FSA found shortcomings in firms' controls in a number of areas, including their use of dealing commission. The FSA asked all investment managers' boards to review their management of conflicts of interest in line with the findings of our report and required their CEOs to attest to the FSA by February 2013, that their firm has arrangements which are sufficient to ensure that conflicts of interest are managed effectively and in compliance with FSA rules.
  - Following this work in 2012, in May 2014, the FCA confirmed updates to its dealing commission rules that took effect in June, following an earlier Consultation Paper.<sup>37</sup> The changes are designed clarify the FCA's expectations to ensure investment managers control the costs from the use of dealing commission appropriately in the best interests of their customers, and that goods and services acquired in return for dealing commission meet the existing rules.<sup>38</sup> Specifically, the FCA clarified that investment managers should only pay for substantive research that relates to investment decisions for their clients with execution commissions, and that these should not be used to pay for corporate access.
  - In July 2014, the FCA published a further discussion paper reporting on a wider review of the dealing commission regime and market for research. This involved thematic supervisory work and a series of roundtable discussions including over 130 firms and other stakeholders.<sup>39</sup> This work was also designed to inform ongoing EU discussions to revise the Market in Financial Instruments Directive

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<sup>35</sup> FCA, Conduct of Business Sourcebook, COBS 2.1 Acting honestly, fairly and professionally: <http://fshandbook.info/FS/html/FCA/COBS/2/1>

<sup>36</sup> FSA, Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks, November 2012: <http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf>

<sup>37</sup> FCA, CP13/17 – Consultation on the use of dealing commission rules, November 2013: <http://www.fca.org.uk/news/cp13-17-use-of-dealing-commission>

<sup>38</sup> FCA, PS 14/7 Changes to the use of dealing commission rules: feedback to CP13/17 and final rules, May 2014: <http://www.fca.org.uk/news/firms/ps14-07-changes-to-the-use-of-dealing-commission-rules>

<sup>39</sup> FCA, DP 14/03 The use of dealing commission regime, July 2014: <http://www.fca.org.uk/news/dp14-03-the-use-of-dealing-commission-regime>

(MiFID), which will introduce reforms in the regulation of investment firms from January 2017. In the Discussion Paper, the FCA indicates its support for changes proposed under the MiFID II, following an ESMA Consultation Paper,<sup>40</sup> which, if implemented, would prevent investment managers from receiving most research in return for dealing commissions – while still allowing managers to pay directly for research. The FCA believes this reform would reduce potential conflicts of interest these arrangements create for investment managers and improve their focus on controlling costs passed to investors, and drive a more transparent, priced market for research. The FCA's discussion period recently closed on 10 October, and they are now reviewing the responses. This will include a careful consideration of respondents' views and any new analysis provided on the impact that further reform to the use of dealing commission rules may have on the market for research. The FCA will publish feedback on the Discussion Paper in due course. In parallel, discussions at ESMA on the detailed requirements for MiFID II are continuing, and they will finalise their technical advice for the European Commission by the end of the year.

- In June 2014, the FCA published a policy statement following a fundamental review of its client assets regime for investment firms. It sets out changes to the FCA's Client Assets rules (CASS) which will affect approximately 1,500 FCA-regulated firms, from the largest investment banks to the smallest investment advisors. These changes should improve firms' systems and controls around segregation, record keeping and reconciliations and set out how investment firms must address specific client assets risks within their business.<sup>41</sup>
- The FCA has also recently launched a broad review of competition issues in the wholesale financial markets to identify any areas that might merit further investigation through an in-depth market study.<sup>42</sup> A call for inputs was published in July 2014.<sup>43</sup> The review is an exploratory exercise that aims to highlight areas from the relevant markets where competition may be weak or not be working properly, amongst other things potentially resulting in sub-optimal outcomes for investment clients. The review will focus primarily on competition in wholesale securities and investment markets, and activities that are related to these, including: markets and market infrastructure; investment banking; asset management; and corporate banking. If the review suggests that a market study is warranted, then such a market study would be launched in early 2015.

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<sup>40</sup> ESMA Consultation paper on MiFID II / MiFIR, May 2014:  
<http://www.esma.europa.eu/consultation/Consultation-Paper-MiFID-II-MiFIR>

<sup>41</sup> FCA PS 14/9, Review of the client assets regime for investment business, June 2014:  
<http://www.fca.org.uk/your-fca/documents/policy-statements/ps14-09>

<sup>42</sup> Details of the FCA competition review into the wholesale markets:  
<http://www.fca.org.uk/news/wholesale-sector-competition-review>

<sup>43</sup> FCA Wholesale sector competition review – Call for inputs, July 2014: <http://www.fca.org.uk/your-fca/documents/market-studies/wholesale-sector-competition-review--call-for-inputs>

- In September 2013, the Office of Fair Trading (OFT) published a market study into the market for defined contribution (DC) workplace pension schemes: in the context of new requirements on employers to automatically enrol eligible employees into a workplace pension scheme.<sup>44</sup> This concluded that competition alone is not sufficient to ensure value for money and made a number of recommendations to Government and regulatory authorities, including on improving the standards of pension scheme governance to ensure that contract-based schemes are managed in the interests of their members.
- Following extensive consultation, and reflecting the findings of the OFT market study, the Government (Department for Work and Pensions) published a command paper in March 2014,<sup>45</sup> setting out its vision for DC workplace pension schemes, proposing a comprehensive range of measures to improve their quality and governance, placing particular importance on protecting those who have been defaulted into private pension saving. As noted above, these measures include new minimum quality standards for DC workplace pension schemes, and require providers of contract-based schemes to operate Independent Governance Committees (IGCs) to protect members' interests. The Government is also strengthening requirements on trust-based schemes, to improve accountability and ensure compliance with the quality standards.
- TPR has also updated its regulatory regime defined contribution (DC) and defined benefit (DB) pension schemes:
  - It published a new strategy for regulating DC schemes in October 2013,<sup>46</sup> This strategy sets out the approach to regulating occupational DC trust-based schemes and for work-based personal pensions (which are regulated jointly by TPR and the FCA. It also published a new Code of Practice on Governance and Administration of Occupational DC trust-based schemes, which came into force from November 2013,<sup>47</sup> and updated Regulatory Guidance for DC schemes.<sup>48</sup>
  - More recently TPR published a new DB strategy in July 2014,<sup>49</sup> a new DB funding policy,<sup>50</sup> and a new Code of Practice on funding DB

<sup>44</sup> OFT Defined contribution workplace pension market study:

[http://webarchive.nationalarchives.gov.uk/20131101164215/http://www.oft.gov.uk/shared\\_oft/market-studies/oft1505](http://webarchive.nationalarchives.gov.uk/20131101164215/http://www.oft.gov.uk/shared_oft/market-studies/oft1505)

<sup>45</sup> DWP Command Paper, Better workplace pensions: Further measures for savers, March 2014: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/298436/better-workplace-pensions-march-2014.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf)

<sup>46</sup> TPR Strategy for regulating DC schemes, October 2013, available at: <http://www.thepensionsregulator.gov.uk/doc-library/strategy-and-policy.aspx>

<sup>47</sup> TPR Code of Practice: Governance and administration of occupational DC trust-based schemes, November 2013: <http://www.thepensionsregulator.gov.uk/codes/code-governance-administration-occupational-dc-trust-based-schemes.aspx>

<sup>48</sup> TPR DC Regulatory Guidance, November 2013: <http://www.thepensionsregulator.gov.uk/guidance/guidance-dc-schemes.aspx>

<sup>49</sup> TPR DB Regulatory Strategy and Funding Policy, July 2014, available at: <http://www.thepensionsregulator.gov.uk/doc-library/strategy-and-policy.aspx>

<sup>50</sup> Ibid

schemes,<sup>51</sup> which came into force from July 2014. This work was in part driven by the need to take account of TPR's new statutory objective 'to minimise any adverse impact on the sustainable growth of an employer' in the context of regulating the funding of DB schemes, which was to ensure that the funding regime is sufficiently flexible and does not act as a brake on investment and growth.

In completing this work TPR has actively considered the Kay Review Principles, Good Practice Statements and directions for regulatory policy and in particular sought to ensure its regulatory guidance on investment matters does not prompt an excessive focus on short-term performance and risk.

### **Transparency on costs and charges in the investment chain:**

2.70. The Kay Review advocated greater transparency of costs and charges in the investment chain, and recommended in particular that asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund (**Recommendation 8**)

2.71. The Government accepted this recommendation. We acknowledged existing industry initiatives in this area, noting that an industry-led approach was likely to be best placed to resolve technical questions on disclosure, we called on the investment and pensions industry to lead in developing a good practice disclosure regime. We set out a clear objective that comprehensive, clear, comparable information on costs and charges should be provided to all savers irrespective of their choice of investment vehicle. We also made clear that the Government and regulatory authorities would consider appropriate regulatory reforms where necessary to further this objective.

2.72. We welcome continued progress on industry good practice in this context and highlight the following in particular:

- In September 2012, the IMA published guidance on enhanced disclosure of fund charges and costs, which recommended additional disclosures on portfolio transaction costs alongside the required disclosures in key investor information document (KIID), and also recommended clear presentation of stock lending income and charges within the ongoing charges figure (OCF).<sup>52</sup>
- In November 2012, the ABI, NAPF, IMA and Society of Pensions Consultants (SPC) jointly published a joint industry code of conduct on the disclosure of pension schemes charges to employers, in the context of the

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<sup>51</sup> TPR Code of Practice: Funding DB, July 2014: <http://www.thepensionsregulator.gov.uk/codes/code-funding-defined-benefits.aspx>

<sup>52</sup> IMA Guidance on Enhanced disclosure of fund charges and costs, available at: <http://www.investmentuk.org/current-topics-of-interest/charges/>

new requirements on employers to enrol eligible employees into a workplace pension scheme.<sup>53</sup>

- In January 2013, the ABI published an agreement on the disclosure of pension charges and costs to employees in contract-based workplace pension schemes. Developed with input from the IMA, the NAPF, the Government and the regulatory authorities, the agreement aims to deliver the consistent and straightforward disclosure, including of investment transaction costs using the IMA's enhanced disclosure guidance. The agreement has already applies to schemes newly established for auto-enrolment, and will apply to all older workplace pension schemes by the end of next year.<sup>54</sup>
- In May 2014 the IMA issued a revised Statement of Recommended Practice (SORP) for the financial statements of UK authorised funds. This includes requirements for more comprehensive disclosure of fund charges, including transaction costs, performance fees and stock lending charges.<sup>55</sup>

2.73. In part responding to the recommendations in the OFT's market study the Government has also set out proposals for improved transparency as part of its package of reforms to DC workplace pension schemes, published in March 2014. From April 2015, trustees of trust-based DC pension schemes and Independent Governance Committees (IGCs) in contract-based schemes will have new duties to consider and report on costs and charges. New requirements will make standardised disclosure of all pension costs and charges mandatory. This information will be disclosed to trustees and IGCs, in a format that enables comparison between schemes, and made available to employers, scheme members and regulators. These reforms build on the industry initiatives described above.

2.74. The FCA has also taken forward a number of initiatives designed to ensure that there is appropriate transparency on costs and charges in the investment chain. We highlight specifically:

- A thematic review on the clarity of fund charges, published in March 2014.<sup>56</sup> This review set out clear expectations, including that firms have a duty to act in the best interest of investors, and must ensure their charges are clear to investors, so they know what they are paying for and can compare funds.

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<sup>53</sup> Pensions Charges Made Clear: Joint Industry Code of Conduct – Telling employers about DC pension charges  
[http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0273\\_Pensions\\_charges\\_made\\_clear\\_code\\_of\\_Conduct.aspx](http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0273_Pensions_charges_made_clear_code_of_Conduct.aspx)

<sup>54</sup> ABI Agreement on the disclosure of pension charges and costs <https://www.abi.org.uk/Insurance-and-savings/Products/Pensions/Saving-into-a-pension/Pension-charges/ABI-agreement-on-pension-charges-and-costs>

<sup>55</sup> IMA Statement of Recommended Practice for the Financial Statements of Authorised Funds <http://www.investmentuk.org/assets/files/consultations/2014/20140513-SORP2014.pdf>

<sup>56</sup> FCA TR 14/7, Thematic Review on Clarity of fund charges, May 2014:  
<http://www.fca.org.uk/static/documents/thematic-reviews/tr1407.pdf>

The FCA made clear that for funds subject to the UCITS Directive, information on charges in marketing material (including websites) must be presented to investors in a way that is consistent with the key investor information document (KIID), i.e. using an ongoing charges figure (OCF) which includes all charges. The Review also noted that this figure excludes performance and transaction costs and endorsed the work of the IMA in issuing guidance on disclosure of such costs. The FCA committed to continue working with the IMA on this matter and asked all authorised fund managers to consider the findings of the review and to review their arrangements accordingly.

- A thematic review on unit-linked funds used by both individual investors and pension schemes, published in October 2013.<sup>57</sup> It reviewed 12 firms which between them manage a significant proportion of the total amount invested in unit-linked funds. The FCA found no material issues that were evident in this sample of firms that could have posed a serious threat to customers' investments. The review concluded that there is no evidence of any significant widespread, systemic failings in the sector. However, some specific issues in some individual firms were found which – if left unchecked – could have led to customers being disadvantaged. The FCA has worked with the industry to fix the issues identified, and in May 2014 the ABI published a revised guide to good practice for unit-linked funds in the light of the findings of the review in order to help introduce improvements across the whole of the unit-linked industry.<sup>58</sup>
- New rules for investment platforms in response to concerns that consumers could not compare the costs of using different platforms.<sup>59</sup> The rules require platforms to be paid only through fees ('platform charges') agreed with the client, and not through payments from fund managers. Cash rebates by providers to consumers (other than small amounts) have also been prohibited, although rebates in units can continue. The aim of the new rules is to introduce transparency of charges, so that, in future, the distinction between advice charges, product charges and platform charges will be clear. The changes also aim to restrict the influence that product providers have on the promotion of one fund over another and align more closely the interests of intermediaries with those of their clients. The new rules came into force on 6 April 2014 for new business, but platforms have two years to move existing consumers to the new charging model. The FCA believes that this new transparency has led to greater competition in the market with many fund charges coming down and more competition in respect of platform charges.

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<sup>57</sup> FCA TR 13/8, Thematic Review on the governance of unit-linked funds, October 2013:  
<http://www.fca.org.uk/news/tr13-8-the-governance-of-unit-linked-funds>

<sup>58</sup> ABI publishes Guide to Good Practice for Unit Linked Funds, May 2014:  
<https://www.abi.org.uk/News/News-updates/2014/05/ABI-publishes-Guide-to-Good-Practice-for-Unit-Linked-Funds>

<sup>59</sup> FCA PS 13/1 Payments to platform service providers and cash rebates from providers to consumers, April 2013: <http://www.fca.org.uk/your-fca/documents/ps13-01-payments-to-platform-service-providers>

## Stock Lending:

- 2.75. The Kay Review also recommended that all income from stock lending should be disclosed and rebated to investors (**Recommendation 10**). The Government welcomed this recommendation and made clear that we would like to see separate disclosure of stock lending income and associated costs and charges adopted by the industry in the context of the development of a more comprehensive industry-led disclosure regime, as discussed above.
- 2.76. We believe that the progress made by the industry on disclosure of costs and charges, and the Government's reforms to the transparency of costs and charges on pension schemes, will improve the disclosure of stock lending income and associated costs and charges.
- 2.77. We also note that the European Securities and Markets Authority (ESMA) guidelines for asset managers of funds subject to the UCITS Directive<sup>60</sup> explicitly makes clear that investors in UCITS funds should receive all the income from stock lending activity net of direct or indirect operational costs.
- 2.78. The Law Commission Review further considered the issues identified by the Kay Review around the risk of misaligned incentives arising from stock lending activity. They noted the requirement on UCITS funds and considered whether it would be appropriate to extend this more broadly to funds outside the UCITS regime. They found that on balance this would provide little benefit, noting that in many cases pension funds negotiate arrangements which are "more advantageous to the investor. They also noted the Government's commitment to ensure the transparency of all pension costs described above.
- 2.79. Accordingly they concluded that a further review of stock lending was not needed at this stage, but recommended that stock lending fees on pensions schemes should be considered further when the Government reviews the cap on charges on default funds in workplace DC pension schemes in April 2017. As noted above, the Government accepts this recommendation.

## Asset Manager Remuneration:

- 2.80. The Kay Review recommended that *asset managers' remuneration should be aligned with the interests and timescales of their clients* (**Recommendation 16**). Professor Kay specifically argued that *asset manager pay should not be related to short-term performance of the investment fund or asset management firm*. Rather he advocated that *long-term performance incentives should be provided in the form of an interest in the fund to be held at least until the manager is no longer responsible for that fund*. He suggested that some flexibility was required and made clear his preference for change through the development of industry good practice, rather than by imposing pay structures in regulation.

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<sup>60</sup> ESMA Guidelines for competent authorities and UCITS management companies on ETFs and other UCITS issues [http://www.esma.europa.eu/system/files/esma-2014-0011-01-00\\_en\\_0.pdf](http://www.esma.europa.eu/system/files/esma-2014-0011-01-00_en_0.pdf)

- 2.81. The Government welcomed this recommendation and has focused on encouraging good practice in this area including in response to the Good Practice Statement for Asset Managers published as part of the Kay Review. We have seen some progress in this area, and in particular note that the NAPF led Stewardship Disclosure Framework described above is prompting asset managers to indicate to their clients the extent to which manager remuneration is linked to long-term portfolio performance. The Government hopes that the further development of this framework will result in greater clarity about client expectations of acceptable remuneration practice in UK asset management firms.
- 2.82. At the same time, negotiations at European level on a new UCITS Directive have also focused on asset management remuneration structures. The Directive, which was adopted in July 2014, regulates around two thirds of all European investment funds and therefore applies to a broad range of asset management firms.<sup>61</sup> The Government welcomes new provisions in the Directive that help align the incentives of fund managers, while recognising the need for proportionate application. These provisions include rules requiring that:
- guaranteed variable remuneration is only to be paid in exceptional circumstances, and only in the context of the first year of employment of new staff;
  - remuneration policy is consistent with and promotes sound and effective risk management. Such policies must also be reviewed at least annually and be in line with the business strategy, objectives, values and interests of the UCITS fund and its investors;
  - a substantial portion of variable remuneration is to be paid in units of the UCITS concerns or other ownership interests; and
  - a substantial portion of variable remuneration deferred for a period appropriate in view of the risks and holding period recommended to investors in the UCITS in question; and
  - staff are prevented from using personal hedging strategies or insurance to undermine the risk alignment effects embedded in their remuneration arrangements.
- 2.83. Taken together with the other requirements set out in the Directive these rules will help ensure that the remuneration of those whose professional activities have a material impact on the risk profiles on UCITS funds are closely aligned with the interests of investors.

### **Executive Remuneration:**

- 2.84. The Kay Review also recommended that *companies should structure directors' remuneration to relate incentives to sustainable long-term business performance*. Professor Kay argued that long-term incentives for company directors should be genuinely linked to long-term business performance. He suggested that the best means to achieve this objective is for company executives to hold company shares until sometime after they have left the

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<sup>61</sup> EU UCITS Directive V: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0091&from=EN>

business: reducing the incentive to focus excessively on the short-term share price. (**Recommendation 15**).

- 2.85. The Government endorsed Professor Kay's view that this recommendation should be achieved by promoting the development of good practice by companies, rather than by mandating a particular structure of company directors' remuneration packages. Companies and their shareholders should be given the flexibility to negotiate remuneration structures that work for the specific circumstances of the company.
- 2.86. The Government introduced comprehensive legislative reforms to the governance of directors' remuneration in October 2013,<sup>62</sup> to address widespread concerns that, in recent years, the remuneration of company directors has been excessive, and increasingly disconnected from long-term company performance. Companies are now required to prepare both a remuneration report, which sets out what each director has been paid in the previous financial year; and a directors' remuneration policy, to which companies are legally bound, which sets out what each director could be paid and how those earnings are linked to performance and company strategy.
- 2.87. Our objectives were to boost transparency, so that what people are paid is clear and easily understood; to promote better engagement between companies and shareholders; and to give shareholders more power through binding votes, so they can hold companies to account more effectively. The Government believes that the reforms we have introduced will encourage companies and their shareholders to agree simpler pay structures which are more clearly linked to long-term performance.
- 2.88. Both companies and shareholders were consulted on the development of the reforms and have been broadly supportive of their implementation. We are grateful in particular for the vital supportive role played by the good practice guidance issued by the GC100 and Investor Group<sup>63</sup> to accompany the Government's regulations.
- 2.89. We have also seen continued progress on the part of institutional investors in setting clearer expectations of good practice for remuneration policies which are simpler and more effectively linked to long-term performance, including through the use of long-term share ownership as Professor Kay proposed. We highlight three examples in particular:
  - In November 2013, the NAPF published "Remuneration principles for building and reinforcing long-term business success", jointly with Hermes

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<sup>62</sup> The Enterprise and Regulatory Reform Act 2013, available at: <http://www.legislation.gov.uk/ukpga/2013/24/contents>; and The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, available at: <http://www.legislation.gov.uk/uksi/2013/1981/contents/made>

<sup>63</sup> The GC100 and Investor Group comprises the Association for the General Counsel and Company Secretaries of the FTSE 100 (GC100), the ABI, and a number of leading pension schemes and investment firms. The GC100 and Investor Group guidance is available at: <http://uk.practicallaw.com/groups/uk-gc100-investor-group>

Equity Ownership Services, the BT Pension Scheme, the Universities Superannuation Scheme and the Railways Pension Scheme, as guidance for companies on their expectations of their remuneration structures and good practice.<sup>64</sup> This contained a number of high level principles and other commentary of direct relevance to the issues highlighted in the Kay review – see box below.

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<sup>64</sup> NAPF / Hermes EOS, Remuneration principles for building and reinforcing long-term business success, November 2013:  
[http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0351\\_remuneration\\_principles\\_for\\_building\\_and\\_reinforcing%20\\_longterm\\_business\\_success\\_nov2013.aspx](http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0351_remuneration_principles_for_building_and_reinforcing%20_longterm_business_success_nov2013.aspx)

## NAPF / Hermes EOS Remuneration Principles

### Principles:

1. Remuneration committees should expect executive management to make a material long-term investment in shares of the businesses they manage.
2. Pay should be aligned to long-term success and the desired corporate culture throughout the organisation.
3. Pay schemes should be clear, understandable for both investors and executives, and ensure that executive rewards reflect long-term returns to shareholders.
4. Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect business performance.
5. Companies and investors should have regular discussions on strategy and long-term performance.

### Extract relevant to the Kay Review recommendation:

*"The meaning of "long-term" will differ from company to company but three years, the most commonly used time period for long-term awards, is often not long enough. In many situations it may be appropriate for a material proportion of shares granted to be held for a longer period, the length of time would be aligned to the business cycle and strategy of the company and take account of the demographic of the executives.*

*Wherever possible, we believe that remuneration committees should foster a culture in which executives are encouraged to invest in the shares of the company they manage. It is important, of course, that the board monitors and guards against the possible unintended consequences of long-term ownership such as overly aggressive dividend policies, encouraging takeovers to crystallise awards and overly risk-averse strategies intended to preserve, rather than increase, the value of shares. In particular, as executives approach retirement they may wish to ensure their investments are appropriately diversified, however, they should continue to maintain a material holding. Having "skin in the game" is an important motivator and one that we believe is under-used.*

*Companies should also consider ensuring that executives are exposed to some tail risk for an appropriate length of time once they leave a company, for example, by requiring that any sale of shares be staggered over time, notwithstanding competitive or regulatory barriers to continued share ownership. In practice, many long-serving executives have significant holdings in the company, but this kind of commitment can help to encourage longer-term thinking to continue right through to the end of a career."*

- Similarly, the ABI updated its Principles of Remuneration in light of the new regulations in November 2013.<sup>65</sup> The updated Principles include clear statements that incentive structures and measurement of performance should have a long-term focus, clearly linked to the implementation of the strategy of the business; that executives should build up a high level of personal shareholding to ensure alignment of interest with shareholders; and that remuneration committees should consider the use of additional holding periods for shares.
- Fidelity Worldwide Investment, one of the largest holders of actively managed equity funds has also recently updated their voting policy to specify that they will oppose long-term incentive plans with a holding period of less than five years after the date shares are awarded. They are also encouraging companies to structure their long-term incentive plans such that at least some of a share award must be held until the executive leaves the company.<sup>66</sup>

2.90. Following public consultation, the FRC has also made a number of revisions to the Corporate Governance Code, including to reflect the Government's reforms to the governance of directors remuneration. The revised Code came into force from 1 October 2014.<sup>67</sup> It now makes clear that companies should place greater emphasis on ensuring that remuneration policies are designed with the long-term success of the company in mind, and that the lead responsibility for doing so rests with the remuneration committee. In particular the revised Code states that companies should further consider the appropriate vesting and holding periods for deferred remuneration – including payment in shares – in line with Professor Kay's recommendations.

### **Impact of the reforms:**

2.91. We are currently monitoring the impact of the reforms in the context of the 2014 reporting and AGM season. Our focus is on developing an understanding of how companies have interpreted and applied the regulations, what trends can be observed in remuneration packages and how shareholders have responded in terms of voting and engagement. To inform this analysis we have commissioned Manifest – a leading proxy voting research and advice agency – to undertake research based on the data they gather on company reports and AGMs. This will complement the evidence and analysis which they and others already publish, as well as our ongoing discussions with stakeholders. Our intention is to publish the key findings from this work and any policy conclusions

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<sup>65</sup> ABI Principles of Remuneration are available at: <https://www.ivis.co.uk/media/5887/ABI-Principles-of-Remuneration-2013-final.pdf> Following the merger of ABI Investment Affairs with the IMA on 30<sup>th</sup> June, 2014, the enlarged IMA (to be renamed The Investment Association in January 2015) has assumed responsibility for guidance previously issued by the ABI.

<sup>66</sup> Financial Times: Fidelity challenges companies on long-term incentives, 22 September 2013: <http://www.ft.com/cms/s/0/d01bf874-21dc-11e3-bb64-00144feab7de.html#axzz3G2iAY4XJ>

<sup>67</sup> FRC Update to Corporate Governance Code, September 2014, available at: <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/September/FRC-updates-UK-Corporate-Governance-Code.aspx>

we draw from it shortly. We have always made clear that this policy remains under review.

- 2.92. However, we note that evidence available so far suggests that companies are increasingly responding to shareholder expectations on remuneration, with signs of restraint on levels of directors' pay and a substantial number of companies simplifying their remuneration policy and linking it more closely to measurable performance, over longer periods of time.<sup>68</sup>
- 2.93. For instance, the latest evidence shows that median total remuneration awarded to FTSE 100 CEOs fell by 5% in 2012 and by a further 7% in 2013.<sup>69</sup> More than a third of FTSE 100 companies have implemented new long term incentive plans in the past 12 months, more than at any time in the last ten years and the number of FTSE 100 companies operating more than one long-term plan falling from 50 to fewer than 30.<sup>70</sup>
- 2.94. More encouragingly, it is increasingly the norm for FTSE100 companies to require directors to hold a minimum number of shares, to align their interests with those of long-term shareholders, as recommended by Professor Kay. Evidence suggests that most now have such requirements in place. A quarter of FTSE100 companies have increased the level of shareholding required by directors over the last year, and the median shareholding requirement for FTSE100 directors is 200% of salary, up from around 150% of salary in 2012. In the largest companies this rises to 300% of salary.<sup>71</sup>
- 2.95. We note however evidence which suggests that a significant number of companies continue to base their performance related pay on earnings per share performance (and other stock market related measures) rather than on strategic performance goals. The Kay Review, and the independent research we are publishing today, both suggest that this approach can create incentives on company executives to focus excessively on short-term share price rather than long-term value creation. We would encourage companies to give further consideration to this issue, and welcome the fact that investors are increasingly pressing them to do so, noting for instance that the NAPF / Hermes EOS Remuneration Principles highlight their concerns in this area:

*"We encourage remuneration committees to design rewards that encourage the specific behaviours required to drive long-term strategic success. Too much of the debate between companies and owners has focused on the minutiae of short to medium term performance conditions. This is exacerbated when the ultimate owners of companies delegate their oversight responsibilities to agents who themselves operate according to short-time horizons. As a result, certain performance measures, such as earnings per share (EPS) and total*

<sup>68</sup> Deloitte Press Release: *FTSE 100 companies respond to new disclosure regulations and voting regime*, 4 September 2014: [http://www.deloitte.com/view/en\\_GB/uk/news/news-releases/61d4c8e00da38410VgnVCM3000003456f70aRCRD.htm](http://www.deloitte.com/view/en_GB/uk/news/news-releases/61d4c8e00da38410VgnVCM3000003456f70aRCRD.htm)

<sup>69</sup> Manifest and MM&K, Annual Survey of Executive Pay, 2014

<sup>70</sup> Deloitte Press Release: *FTSE 100 companies respond to new disclosure regulations and voting regime*, 4 September 2014.

<sup>71</sup> Ibid.

*shareholder return (TSR) have been overemphasised, with little regard for the company's specific strategy or the timeframe over which that strategy should be achieved. Rather, we believe remuneration committees should take as a starting point the company's strategic plan and key performance indicators (KPIs) and ensure there is a strong read across from the company's strategy to the drivers of executives' remuneration."*

- 2.96. We have also seen positive signs of constructive engagement between companies and investors, with several companies amending their remuneration policies after listening to shareholders' concerns, and investors voting against both remuneration reports and remuneration policies where they deem them disproportionate. However, greater shareholder dissent is of course not, in itself, the objective of the Government's reforms. Indeed, we hope that over time, as companies develop a clearer understanding of shareholders expectations of good practice on remuneration, shareholders will feel able to spend less time engagement and voting on issues of pay and more on effective support and challenge of companies' long-term strategy. We acknowledge that the transition to the new requirements has posed challenges for both companies and shareholders.
- 2.97. In this context we have noted the concerns that have been raised by stakeholders about some approaches taken by companies in interpreting the regulations, and the resulting levels of transparency and accountability to shareholders. The research we have commissioned will enable us to take a clear and objective view as to whether these concerns are well founded.

### **Takeovers:**

- 2.98. The Kay Review found that short-term incentives on corporate management, market participants and advisors have led in some cases to takeovers which are neither in the public interest, nor in the long-term interests of investors. Professor Kay was also critical of companies whose strategies place too great an emphasis on mergers and acquisitions relative to the development of their existing business operations.
- 2.99. Professor Kay stopped short of recommending an extension of powers for Government to intervene in takeovers. He did however recommend that BIS, and indeed companies themselves, should keep the scale and effectiveness of merger activity of and by UK companies under careful review (**Recommendation 4**).
- 2.100. The Government accepted this recommendation, and in the context of its Industrial Strategy, committed to improving engagement with companies and investors to promote investment which benefits the UK economy. In particular the Strategic Relationship Management Programme, led by UK Trade and Investment, has helped to establish better relationships with both foreign and domestic investors and key exporters. The Government now has strategic relationships with 76 of the world's most significant international companies across 16 sectors.

- 2.101. It is important to be clear that the Government's role in relation to this recommendation is to keep merger activity as a whole under review, and not specifically consider the question of foreign ownership. The UK has always welcomed long-term foreign investment in Britain and continues to do so, acknowledging the importance of open markets for growth. Foreign companies can bring in new ideas, technologies and skills to the UK, stimulating productivity and growth in UK firms and opening up new markets for trade. The UK benefited from over 1,500 inward investment projects in 2012/13 which created or safeguarded more than 170,000 jobs. We believe that being attractive to investment from around the world is key to sustaining the UK's economic recovery. Professor Kay's analysis supported this position.
- 2.102. The Commons Business, Innovation and Skills Select Committee, in its July 2013 report on the Kay Review<sup>72</sup>, recommended that the Government study the impact of foreign takeovers on UK companies over the past 25 years. In response, the Government noted that the Economic and Social Research Council (ESRC) had already commissioned a survey of the available research evidence on the impact on foreign ownership in 2011.<sup>73</sup> Nonetheless, we committed to review any relevant research published since 2011 in time for this progress report.
- 2.103. Studies since 2011 have focused on precise aspects of the takeover process, rather than on the impact of foreign takeovers on the British economy. However, a 2013 study carried out for BIS by the M&A Research Centre (MARC) at Cass Business School, found that in the UK from 1997 to 2010, takeovers have added, on average, £178m to the economy per deal through increased shareholder value. Analysis of the longer term impact is less conclusive, however the study found that there was a positive employment impact following M&A, driven by either further acquisitions or organic growth. Analysis of the combined firm, measuring the effect on employment provided some evidence that firms involved in M&A transactions add to overall employment at a higher rate than their industry peers.<sup>74</sup>
- 2.104. Overall we believe that the broad conclusions of the 2011 survey remain valid. In summary, the evidence shows that there are positive overall effects for UK competitiveness and business performance, and an overall positive effect on UK employment, from having an open economy. It also suggests however, that the experience of individual companies and communities vary and can involve both positive and negative consequences from a takeover, depending on other factors including the intentions of the acquiring company and the specific circumstances in the company and industry sector. Accordingly, the Government continues to believe our approach is sound in light of the available

<sup>72</sup> Business, Innovation and Skills Committee, Third Report: The Kay Review of UK Equity Markets and Long-Term Decision Making, July 2013, available at:

<http://www.publications.parliament.uk/pa/cm201314/cmselect/cmbis/603/60302.htm>

<sup>73</sup> Economic and Social Research Council (ESRC) Evidence Briefing: Foreign ownership and consequences for British business, available at: [http://www.esrc.ac.uk/\\_images/8-13313Foreign%20ownership%20and%20consequences%20for%20British%20business.pdf](http://www.esrc.ac.uk/_images/8-13313Foreign%20ownership%20and%20consequences%20for%20British%20business.pdf)

<sup>74</sup> A Guide to M&A in the UK: A study of post-transaction shareholder wealth creation, company financial performance and employment, CASS Business School (September 2011)

evidence: welcoming foreign investment in UK industry, while expanding and improving the Government's strategic relationships with business to ensure that investment supports sustainable long-term growth.

- 2.105. A number of recent high-profile proposed takeovers have sparked renewed public debate about the impact of mergers and takeovers, both in terms of the value they deliver for companies and investors, and broader matters of national interest. Consideration of mergers and acquisitions on competition grounds is handled by the UK's independent Competition and Markets Authority (CMA) or the European Commission, depending on the operational scope of the companies involved. The CMA has a clear objective of supporting long-term growth built into its performance framework.
- 2.106. The UK Government may take appropriate measures to protect legitimate interests so long as they are compatible with the general principles and other provisions of EU law. Public security, plurality of the media and prudential rules are legitimate interests under the EU Merger Regulation, the mechanism that provides control of mergers at EU level. Scope for new criteria is limited and would require secondary legislation and Commission approval. In the case of mergers being considered by the UK authorities, the grounds for intervening are national security, media plurality and financial stability.
- 2.107. Further there are some cases where stakeholders may have concerns about the impact on a particular industry. The most recent example of this was in the mooted takeover bid by Pfizer of Astra Zeneca. In response to the concerns raised by stakeholders, Pfizer took the unusual step of indicating that they would be willing to offer significant and binding long-term commitments regarding their company strategy in the UK. In the event, the company decided not to make an offer for AstraZeneca. However, in light of Pfizer's proposals, the Takeover Panel reviewed the operation and effect of the provisions of the Takeover Code in this area.
- 2.108. The Takeover Panel has consulted on proposed changes to the Code to introduce a two-tier regime that would distinguish between "post-offer undertakings" and "post-offer intention statements"<sup>75</sup>. Amongst other things, it has proposed that companies giving "post-offer undertakings" should be required to comply with the course of action(s) set out for the period of time specified; that currently permissible qualifications such as "material change of circumstances" clauses should be prohibited for such undertakings, with only explicit qualifications and conditions allowed in future; and that a new monitoring regime should be introduced.
- 2.109. The Government welcomes the Panel's proposals. The increased clarity in the statements that a company would need to provide when making undertakings would help all parties understand better the strength of its commitment. And the proposed new monitoring arrangements will allow the Panel to intervene quickly

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<sup>75</sup> The Takeover Panel, Consultation Paper: Post Offer Undertakings and Intention Statements, PCP 2014/2, 15 September 2014, available at: <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/PCP201402.pdf>

to take enforcement action if it is satisfied that there is a reasonable likelihood that a company will breach a commitment.

2.110. We have considered whether there is any action that the Government itself needs to take to support the introduction of this new two-tier system. This was specifically in relation to introducing sanctions to apply in cases where commitments are not honoured. Following extensive discussions with the Panel, the Government has accepted the Panel's advice that there is no need for additional sanctions over and above those that are already available to the Panel. The Panel has assured the Government that it is confident that the new arrangements would provide it with an effective means of supervising compliance, which would alert it to any actual or threatened breach. In the event that action is needed, the powers and sanctions already available to the Panel, with recourse to the courts if necessary, should enable the Panel to enforce such undertakings effectively. These new arrangements are very similar to the sanctions regime already available to the Competition and Markets Authority for breaches of mergers undertakings.

2.111. It is also worth recalling that these changes follow an earlier review of aspects of the Code in 2011, encouraged by the Government, which led to the Takeover Panel making a series of changes designed to strengthen the position of target companies in the face of unwelcome takeovers.<sup>76</sup> Specifically, the Panel:

- increased the protection for target companies. Potential bidders now have only 28 days to "put up or shut up", i.e. to announce a firm intention to bid or withdraw.
- strengthened target companies' position. The Code is now explicit that target boards can consider other longer-term considerations, not just the offer price. In addition most inducement fees were banned.
- Improved transparency, by requiring greater disclosure of the bidder's plans, disclosure of offer related fees, and greater detail on the financing of the offer.
- gave greater recognition to the interests of employees. Employee representatives were also given an improved ability to make their views known.

2.112. The Takeover Panel reviewed these amendments in November 2012 and found that they have operated satisfactorily. It continues to keep these broader aspects of the Code under review.

2.113. The combination of the 2011 Code changes and the current proposed Code changes represent a step-change in ensuring that company mergers are motivated by long-term considerations, with appropriate opportunities for stakeholders' views to be heard, and that companies are then held to their commitments. In turn, this will strengthen the UK's takeover regime, to the benefit of the UK's companies, employees, and wider economy.

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<sup>76</sup> The Takeover Panel, Consultation Papers PCP2010/2, Review of certain aspects of the regulation of takeover bids, June 2010: <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/PCP201002.pdf> and PCP2010/2, Proposed amendments to the Takeover Code, March 2011: <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/PCP201101.pdf>

### **The role of short-term shareholders in takeover bids:**

- 2.114. The BIS Select Committee Report also recommended that the Government study the feasibility of a policy to restrict the role of short-term shareholders during a takeover bid. In its response to the report, the Government indicated support for the aim of ensuring that the interests of those seeking short-term returns from a merger or acquisition do not override the long-term interests of the companies involved. However, the Government also made clear that proposals to disenfranchise short-term shareholders would be both practically difficult to introduce and largely ineffective in achieving the objective. We published a summary of this analysis as part of the Government response.<sup>77</sup>
- 2.115. However, the Government response also included a commitment to test this analysis further by inviting comments from interested parties and convening a roundtable of expert stakeholders, representing a variety of perspectives on equity markets. The Government sought to define the disenfranchisement measure specifically, and then focus on whether and how such a measure could work in practice.
- 2.116. Overall, the discussion reached a clear consensus broadly in line with the Government's previous analysis. It concluded that there are a series of legal and technical implementation issues which would be extremely difficult to overcome. In particular it would not be possible to identify precisely, at any given time, which shares had been disenfranchised and which shares still carried the right to accept a takeover offer. Moreover, the practical consequences and impacts of a disenfranchisement measure risked being at best ineffective and at worst damaging, for instance such measures could prevent existing long-term shareholders seeking to resist a takeover, or "white knights" from purchasing additional shares to strengthen their position. Finally, it appeared unlikely that a disenfranchisement measure would eliminate the influence of short-term shareholders in a takeover bid: in particular the measure would simply encourage investors not to trade in shares but rather to trade off market in the economic interests of those shares.
- 2.117. A full note of the roundtable discussion is published today alongside this progress report. In light of these conclusions and the level of consensus among those attending, we have no plans to introduce a disenfranchisement measure.
- 2.118. The Government also received suggestions, in advance of the roundtable, that it might also explore the merits of mandating either the use of qualifying periods on all shares before voting rights (on takeover bids or other matters) accrue to shareholders; or the use of loyalty based ownership structures under which shareholders receive additional voting rights, enhanced dividends or further shares after a certain period. The Government notes that UK company law is sufficiently flexible to permit these approaches to rewarding long-term

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<sup>77</sup> Government response to the BIS Select Committee Report on the Kay Review, Annex B: Summary of analysis of the policy proposal to disenfranchise short-term shareholders during a takeover bid, November 2013, available at:

<http://www.publications.parliament.uk/pa/cm201314/cmselect/cmbis/762/76206.htm>

shareholding, should companies and their shareholders wish to introduce them. However we have seen little evidence of demand for such approaches from either companies or investors, at least with respect to publicly traded company equities. UK institutional investors have historically placed a high value on the principle of "one share, one vote" and have expressed concerns that differential voting rights can allow majority shareholders to have too much control and can be used to entrench company boards and weaken governance. The Government does not therefore plan any further specific policy measures in respect of such approaches, though it is of course important that they remain available to companies that wish to adopt them.

### **Enabling Individual Direct Electronic Shareholding:**

- 2.119. The Kay Review noted that many individual shareholders are naturally inclined to be long-term investors who take an interest in the companies in which they invest. Professor Kay sought to address concerns that the electronic intermediated shareholding model created barriers to engagement, and uncertainty for individual investors, recommending that the Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register (**Recommendation 17**).
- 2.120. The Government committed to address this recommendation in the context of EU policy proposals relating to central securities depositories and securities law. We made clear in the context of these negotiations that there should be scope for investors to hold shares in a way that increases shareholder transparency and facilitates them exercising their shareholder rights.
- 2.121. As noted above, the Law Commission's recent report on fiduciary duties in the investment chain also identified issues with the system of intermediated shareholding, and recommended that the Government review the current operation of the system of intermediated shareholding, with a view to taking the lead in negotiating solutions at a European or international level.
- 2.122. The EU Central Securities Depositories Regulation (CSDR)<sup>78</sup> came into force in September. The Regulation mandates dematerialisation (i.e. the abolition of paper certificates) for transferable securities admitted to trading venues, by 2023 for newly issued securities, and by 2025 for all securities. This requirement will apply to holdings of certificated shares. From this year, all transactions in transferable securities on trading venues will also need to be dematerialised during the settlement process, although before 2025 this will not prevent the later rematerialisation of these securities. Moving to a fully dematerialised system for holding securities will in many cases make settlement quicker and more efficient.
- 2.123. As part of the UK's implementation of dematerialisation, the Government (HM Treasury and BIS) will consider whether our system for holdings of dematerialised securities works effectively and efficiently for both investors and issuers. This work will include continuing to explore (in discussion with the FCA

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<sup>78</sup> Regulation (EU) No 909/2014: <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1410876555408&uri=CELEX:32014R0909>

and key stakeholders) the most cost effective means for individual investors to hold shares directly on an electronic register, should they wish to do so, as recommended by the Kay Review. BIS is currently inviting tenders for research to inform the development of this work through its Research and Evaluation Procurement Framework. This research will seek to improve our understanding of both individual and institutional investors' experiences of intermediated share ownership, and whether reform would be desirable.

2.124. CSDR also mandates for the first time that direct participants in Central Securities Depositories, such as CREST, must offer their clients a choice of both individually segregated ('designated') and omnibus ('pooled') accounts on reasonable commercial terms and disclose the protections afforded and costs of each level of segregation they offer. This is intended to provide greater choice and transparency in the system of intermediated shareholdings.



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