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

FINAL REPORT

JULY 2012

Executive Summary

i In June 2011, the Secretary of State for Business, Innovation and Skills asked me to review activity in UK equity markets and its impact on the long-term performance and governance of UK quoted companies. The Review's principal concern has been to ask how well equity markets are achieving their core purposes: to enhance the performance of UK companies and to enable savers to benefit from the activity of these businesses through returns to direct and indirect ownership of shares in UK companies. More detail on the background to the Review, including its terms of reference and the Interim Report, can be found at www.bis.gov.uk/kayreview.

ii This final report details the findings of the Review. Overall we conclude that short-termism is a problem in UK equity markets, and that the principal causes are the decline of trust and the misalignment of incentives throughout the equity investment chain. These themes of trust and incentives are central to this report. We set out principles that are designed to provide a foundation for a long-term perspective in UK equity markets and describe the directions in which regulatory policy and market practice should move. These high level statements are supported by specific recommendations that are aimed at providing the first steps towards the re-establishment of equity markets that work well for their users.

iii Given the systemic nature of the problems the Review has identified, our principles and recommendations are not limited to steps that Government should take, but are also addressed to regulatory authorities and key players in the investment chain. No single reform will provide the solution, but when implemented together, we believe our recommendations will help to deliver the improvements to equity markets necessary to support sustainable long-term value creation by British companies.

iv Our proposals aim to:

- Restore relationships of trust and confidence in the investment chain, underpinned by the application of fiduciary standards of care by all those who manage or advise on the investments of others
- Emphasise the central function of trust relationships in financial intermediation and diminish the current role of trading and transactional cultures
- Establish high level Statements of Good Practice for key players in the investment chain – Asset Holders, Asset Managers and Company Directors
- Address the disincentives to engagement by asset managers with investee companies that arise from fragmented shareholding and the perceived regulatory barriers that inhibit collective engagement, by establishing an investors' forum for institutional investors in UK companies
- Improve the quality of engagement by investors with companies, emphasising and broadening the existing concept of stewardship
- Increase incentives to such engagement by encouraging asset managers to hold more concentrated portfolios judged on the basis of long-term absolute performance
- Shift regulatory philosophy and practice towards support for market structures which create appropriate incentives, rather than seeking to counter inappropriate incentives through the elaboration of detailed rules of conduct
- Tackle misaligned incentives in the remuneration practices of company executives and asset managers, the disclosure of investment costs, and in stock lending practices

- Reduce the pressures for short-term decision making that arise from excessively frequent reporting of financial and investment performance (including quarterly reporting by companies), and from excessive reliance on particular metrics and models for measuring performance, assessing risk and valuing assets.

The sources of short-termism – the erosion of trust and the misalignment of incentives.

v Chapters 1-5 of this report present our assessment of the main problems in equity markets.

vi Short-termism in business may be characterised both as a tendency to under-investment, whether in physical assets or in intangibles such as product development, employee skills and reputation with customers, and as hyperactive behaviour by executives whose corporate strategy focuses on restructuring, financial re-engineering or mergers and acquisitions at the expense of developing the fundamental operational capabilities of the business.

vii We observe a wide variety of examples of companies that have made bad long-term decisions, and consider that equity markets have evolved in ways that contribute to these errors of managerial judgment. We conclude that the quality – and not the amount – of engagement by shareholders determines whether the influence of equity markets on corporate decisions is beneficial or damaging to the long-term interests of companies. And we conclude that public equity markets currently encourage exit (the sale of shares) over voice (the exchange of views with the company) as a means of engagement, replacing the concerned investor with the anonymous trader.

viii UK equity markets are no longer a significant source of funding for new investment by UK companies. Most publicly traded UK companies generate sufficient cash from their day-to-day operations to fund their own corporate projects. The relatively small number of UK companies which access the new issue market often use it as a means to achieve liquidity for early stage investors, rather to raise funds for new investment. We conclude that the principal role of equity markets in the allocation of capital relates to the oversight of capital allocation within companies rather than the allocation of capital between companies. Promoting good governance and stewardship is therefore a central, rather than an incidental, function of UK equity markets.

ix We chart the evolution of the structure of shareholding in UK equities. We find increased fragmentation, driven by the diminishing share of large UK insurance companies and pension funds and by the globalisation of financial markets which has led to increased foreign shareholding. This fragmentation has reduced the incentives for engagement and the level of control enjoyed by each shareholder.

x At the same time, there has been an explosion of intermediation in equity investment, driven both by a desire for greater professionalism and efficiency and by a decline in trust and confidence in the investment chain. The growth of intermediation has led to increased costs for investors, an increased potential for misaligned incentives and a tendency to view market effectiveness through the eyes of intermediaries rather than companies or end investors.

xi Bad policy and bad decisions often have their origins in bad ideas. We question the exaggerated faith which market commentators place in the efficient market hypothesis, arguing that the theory represents a poor basis for either regulation or investment. Regulatory philosophy influenced by the efficient market hypothesis has placed undue reliance on information disclosure as a response to divergences in knowledge and incentives across the equity investment chain. This approach has led to the provision of large quantities of data, much of which is of little value to users. Such copious data provision may drive damaging short-term decisions by investors, aggravated by well-documented cognitive biases such as excessive optimism, loss aversion and anchoring.

xii Asset managers – specialist investment intermediaries – have become the dominant players in the investment chain, as individual shareholding has declined and pension funds and insurers have responded to incentives (including demographic changes and regulation) to reduce their investments in equities. Asset managers typically play a key role in exercising the attributes of share ownership most relevant to company decision making: the right to vote and the right to buy or sell a given share.

xiii We focus on the important, though not clear-cut, distinction among asset managers between those who "invest" on the basis of their understanding of the fundamental value of the company and those who "trade" based on their expectations of likely short term movements in share price. While some trading is necessary to assist the provision of liquidity to investors, current levels of trading activity exceed those necessary to support the core purposes of equity markets.

xiv The appointment and monitoring of active asset managers is too often based on short-term relative performance. The shorter the timescale for judging asset manager performance, and the slower market prices are to respond to changes in the fundamental value of the company's securities, the greater the incentive for the asset manager to focus on the behaviour of other market participants rather than on understanding the underlying value of the business.

xv But competition between asset managers on the basis of relative performance is inherently a zero sum game. The asset management industry can benefit its customers – savers – taken as a whole, only to the extent that its activities improve the performance of investee companies. This conflict between the imperatives of the business model of asset managers, and the interests of UK business and those who invest in it, is at the heart of our analysis of the problem of short-termism.

xvi Regulatory policy has given little attention to issues of market structure and the nature and effectiveness of competition, instead developing detailed and often prescriptive rules governing market conduct, with substantial cost and limited success. Regulation should focus on the establishment of market structures which provide appropriate incentives, rather than the fruitless attempt to control behaviour in the face of inappropriate commercial incentives. We look forward to a future of less intrusive and more effective regulation, the product of a new emphasis on the incentives market participants face, and to the creation of trust relationships which can give savers and companies confidence that the equity investment chain meets their needs and serves their interests.

xvii Chapters 6-12 of this report describe the reforms we believe are needed to ensure that equity markets support long-term corporate performance. The key principles and specific recommendations we advocate are set out below.

Kay Review Principles

1. All participants in the equity investment chain should act according to the principles of stewardship, based on respect for those whose funds are invested or managed, and trust in those by whom the funds are invested or managed.
2. Relationships based on trust and respect are everywhere more effective than trading transactions between anonymous agents in promoting high performance of companies and securing good returns to savers taken as a whole.
3. Asset managers can contribute more to the performance of British business (and in consequence to overall returns to their savers) through greater involvement with the companies in which they invest.
4. Directors are stewards of the assets and operations of their business. The duties of company directors are to the company, not its share price, and companies should aim to develop relationships with investors, rather than with 'the market'.
5. All participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers. Fiduciary standards require that the client's interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed. These standards should not require, nor even permit, the agent to depart from generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards.
6. At each stage of the equity investment chain, reporting of performance should be clear, relevant, timely, related closely to the needs of users and directed to the creation of long-term value in the companies in which savers' funds are invested.
7. Metrics and models used in the equity investment chain should give information directly relevant to the creation of long-term value in companies and good risk adjusted long-term returns to savers.
8. Risk in the equity investment chain is the failure of companies to meet the reasonable expectations of their stakeholders or the failure of investments to meet the reasonable expectations of savers. Risk is not short-term volatility of return, or tracking error relative to an index benchmark, and the use of measures and models which rely on such metrics should be discouraged.
9. Market incentives should enable and encourage companies, savers and intermediaries to adopt investment approaches which achieve long-term returns by supporting and challenging corporate decisions in pursuit of long-term value.
10. The regulatory framework should enable and encourage companies, savers and intermediaries to adopt such investment approaches.

Kay Review Recommendations

1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.
2. Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should takes steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements.
3. An investors' forum should be established to facilitate collective engagement by investors in UK companies.
4. The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves.
5. Companies should consult their major long-term investors over major board appointments.
6. Companies should seek to disengage from the process of managing short term earnings expectations and announcements.
7. Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.
8. Asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund.
9. The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers.
10. All income from stock lending should be disclosed and rebated to investors.
11. Mandatory IMS (quarterly reporting) obligations should be removed.
12. High quality, succinct narrative reporting should be strongly encouraged.
13. The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations.
14. Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment.
15. Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business.
16. Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund.
17. The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.

specified period. This might be a general rule or one specifically applicable during takeover. We were persuaded that the introduction of such provisions by legislation or regulation would involve practical difficulties and would be unlikely to achieve the intended effect. The approach we have recommended – the development of stewardship – should in the long-term achieve that effect.

8.33 UK companies are already legally free to create different share classes with differential voting rights. Two notable recent US flotations – those of Google and Facebook – have involved such a structure, and it is less likely that the founders of these companies, who are anxious to maintain their influence on the distinctive character of their organisations, would have agreed to an IPO if such an arrangement had not been possible.

8.34 However multiple share classes are viewed with considerable hostility by UK institutional investors. The ABI, which led the historic opposition to these structures – a stance which led to the virtual elimination of dual class share structures amongst UK listed companies – told us that they remain strongly opposed. We consider this issue should be a subject of continued review and discussion. The challenge is to advantage engagement by committed shareholders without undermining protections for minority shareholders.

8.35 A number of respondents took the view that relationships between companies and shareholders would be more effective if shareholders took a part in the selection of chairmen and/or non-executive directors. They proposed the establishment of shareholders' committees. A slightly different suggestion was that such a committee might provide a means of involving small shareholders more in the affairs of a company.

8.36 We think that the investors' forum might provide a means through which companies could, and might in time be expected to, consult their main shareholders over chairmen and important non-executive appointments, in addition to the opportunities for such discussions which closer relationships between asset managers and companies would provide.

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

8.37 When individual shareholders were predominant, analysts employed by stockbrokers played a major role in the assessment of company capabilities and performance. Their function was to provide research for salesmen who would use the material provided to them to encourage their clients to trade. As insurance companies, pension funds and unit trusts became more important as holders of UK equities, analysts directed their attention towards institutions. After Big Bang, most independent stockbrokers were acquired by large financial institutions. Analysts became employees of investment banks or other firms seeking corporate advisory and issuance business. There has always been a conflict of interest in the role of the analyst: the traditional function of equity analysis was to promote equity trading but, while that function remains, the more immediate conflict of interest faced by the equity analyst today comes from the need to maintain good relationships with the employer's corporate clients.

8.38 Following the new economy bubble, which revealed instances of crass promotion by analysts in investment banks of stocks the analysts knew to have little or no value, and the Myners Report in 2001, attempts have been made in both the US and the UK to promote independent stock analysis. But these efforts have enjoyed limited success. We were told that it is difficult for independent firms to compete for talented staff with businesses which can cross-subsidise analysis from their issuance and corporate

advisory business, and also difficult to persuade asset managers to pay fees for research out of their own resources, rather than to 'buy' research access by directing dealing commissions, costs which can be charged to the funds under their management.

8.39 The analyst has always sought to provide news stories about the company which will arouse the interest of investors. As the relationships between analysts and companies have been more tightly regulated, the focus of analysts' attention has increasingly been directed to the anticipation and interpretation of company statements. Analysts compete with each other to predict the content of an announcement, and the company will often join in this process by providing earnings 'guidance'. Managing earnings expectations becomes a principal concern of the company's financial officer and investor relations personnel. The exercise need have little, if any, connection to the underlying competitive capabilities of the business.

8.40 Several corporate executives described this process to us. We hear several statements of the kind 'we found little interest in discussions of corporate strategy and developments, they were concerned with the numbers'. This dysfunctional process of earnings management and earnings guidance has not yet reached the scale achieved in the US, where a recent survey showed that 78% of respondent companies would be willing to reduce discretionary spending on research and development, advertising and hiring in order to meet earnings benchmarks[32]. But we believe it is important that the UK should not move any further in this damaging direction.

8.41 Looking forward, we see the sell-side analyst as a dispensable link in the chain of intermediation. Issuers will certainly wish to employ sales people, and these issuers will need to undertake their own research on their own behalf in preparing documentation for prospective buyers. But sales and due diligence are very different from research which, to be useful to investors, should involve an understanding on the competitive position of the company and the sources and sustainability of its competitive advantages. Most asset management firms now undertake their own analysis and employ their own analysts. Not only is it right that they should do so – this is the service for which they are paid – but the independent asset manager, unlike the securities issuer, is able to undertake research into the long-term capabilities of a company free of conflict of interest.

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

[32] Graham, J, Harvey, C, & Rajgopal, S 2005, 'The Economic Implications of Corporate Financial Reporting', *Journal Of Accounting And Economics*, 40, 1-3, pp. 3-73, EconLit with Full Text, EBSCO*host*, viewed 10 July 2012