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

FINAL REPORT

JULY 2012

I would like to thank everyone who has contributed to the Kay Review, particularly for the insights, experience and expertise I received through the 'Call for Evidence'.

I am indebted to the many people who committed their time to meet my team and myself to discuss the issues in detail, through which we were able to obtain constructive and thoughtful input. I found these meetings especially useful as I continued to develop my thinking and recommendations. I hope many will see the points they raised reflected in this report.

I would like to thank a number of people who supported the production of the Review, for their enthusiasm and input. I should like to thank everyone in the Department for Business, Innovation and Skills who supported me and in particular the members of the Review Secretariat, led by Andrew Busby and Alastair Cowie. I would also like to recognise the important contribution of the group of friends I established early on in the Review with whom I exchanged ideas freely but privately. Their input was immensely helpful and I am appreciative for the time they committed to this Review.

Finally, I am, of course, grateful to Chris Hitchen, James Anderson and Sir John Rose, who agreed to be members of my Advisory Board team. The experience and knowledge they have brought to this Review has been invaluable.

Foreword

British business must invest and must develop its capacity for innovation, its brands and reputations, and the skills of its workforce. Only in this way can we create and sustain the competitive advantages in global markets which are necessary to maintain our prosperity. Through success in world markets, British companies will earn the returns on investment which are necessary to pay our pensions and enable us to achieve our long-term financial goals. In June 2011 the Secretary of State for Business, Innovation and Skills asked me to review whether equity markets in the UK gave sufficient support to these key objectives.

There was wide agreement amongst those who submitted evidence to the Review that equity markets today were not as effective as they should be in supporting these purposes. The interim report of this Review in February 2012 summarised that evidence. This final report should be read in conjunction with that summary of evidence.

The present, final, report is based on the evidence received then, on discussions with the Advisory Board to the Review and on the further submissions made in response to our interim report. The Review Team and I have conducted a wide range of consultations with individuals and organisations in business and the financial community, and organised a number of round tables which brought together people from a wide range of backgrounds as 'friends of the Review'. These discussions have contributed greatly to the present document.

Financial intermediation depends on trust and confidence: the trust and confidence that savers who invest funds have in those they choose to manage these funds, and the trust and confidence of investors in the businesses they support. Trust and confidence are the product of long-term commercial and personal relationships: trust and confidence are not generally created by trading between anonymous agents attempting to make short term gains at each other's expense.

Trust and confidence, or their absence, are the product of the prevailing culture. Incentives matter: not because, as some people crudely think, financial rewards are the only human motivation – although there are some people of whom that is true, and many of them are to be found in the financial sector. Most people have more complex goals, but they generally behave in line with the values and aspirations of the environment in which they find themselves. We must create cultures in which business and finance can work together to create high performing companies and earn returns for savers on a sustainable basis.

These themes – the dependence of successful financial intermediation on trust and confidence, the importance of incentives – are central to this Report. Taken together, rather than separately, they imply a financial world different from our recent experience.

John Kay.

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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.

1 Short & long-term decisions

1.1 Short-termism, or myopic behaviour, is the natural human tendency to make decisions in search of immediate gratification at the expense of future returns: decisions which we subsequently regret. We speak and act in the heat of the moment, we eat and drink too much, and we do not save enough. In business, short-termism occurs when companies invest too little, either in the physical assets of the business or in the intangibles which are generally the source of their competitive advantage – their reputation, their capacity for innovation, and in the skills and capabilities of their employees.

1.2 Short-termism can also manifest itself in hyperactivity. Hyperactive individuals fail to give sustained attention to tasks while demanding the attention of others for themselves. In the corporate sector, hyperactivity can be seen in frequent internal reorganisation, corporate strategies designed around extensive mergers and acquisitions, and financial re-engineering which may preoccupy senior management but have little relevance to the capabilities of the underlying business.

1.3 The epic story of Ulysses tying himself to the mast to resist the call of the sirens demonstrates the length of the history of attempts to construct devices and institutions to combat our instinctive short-termism. The central question for this Review is whether capital markets in Britain today dissuade or stimulate the search for instant gratification in the corporate sector.

1.4 Examples of short-term behaviour in capital markets are easy to find. A high proportion of dealing in equity markets today is conducted by high frequency traders, whose time horizons are typically measured in fractions of a second. Such activities are conducted by computers using programmed algorithms, since the speed of response required is far beyond the capacity of any human being[1]. More generally, the trading floors of investment banks exemplify hyperactive behaviour.

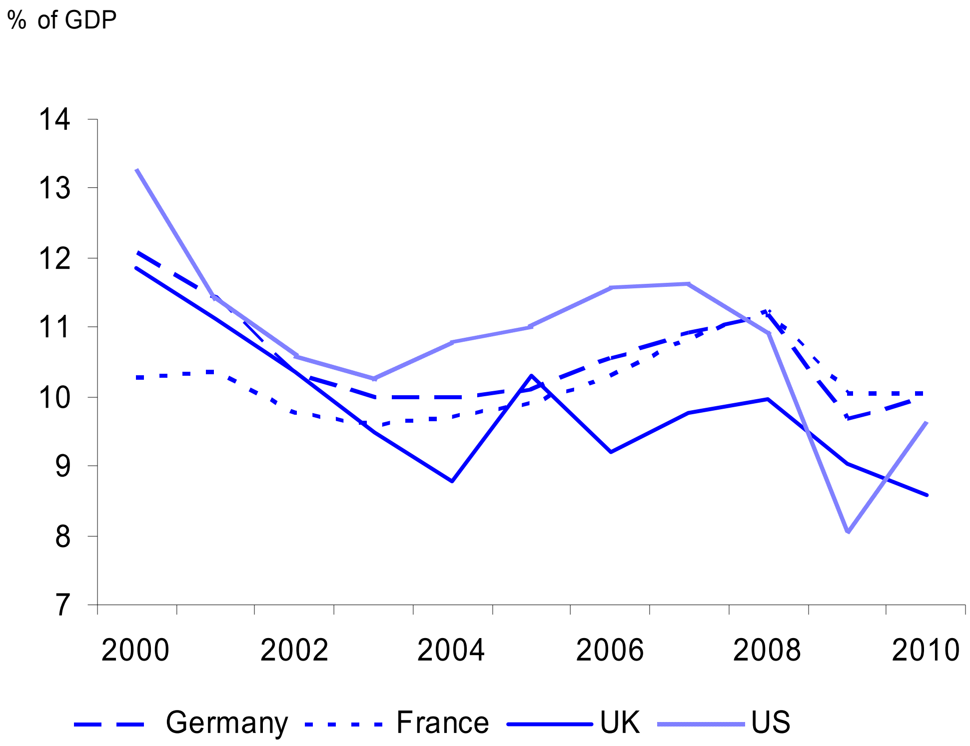
1.5 However, although these superficial manifestations are suggestive, they are not in themselves evidence of damaging short-term behaviour in the decisions that matter to the British economy. The outcome, not the process, is what matters, and that perspective has been central to this Review. From the outset, we have emphasised that the goals of equity markets are to operate and sustain high performing companies and to earn good returns for savers without undue risk[2]. The two perspectives are essentially identical. In the long run, the profits earned by high performing companies are the only source of returns for savers who invest in equities.

1.6 We do not know how much companies should invest. We do, however, know how much they do invest. As a share of national income, business investment in the UK has declined over the past decade (see Figure 1). This decline is not the result of the credit crunch of 2007-8 and the recession that followed; that setback continues a trend to lower investment which was evident throughout the years of steady growth that preceded the financial crisis.

[1] Haldane, A. (2011), The race to zero, Bank of England Speech. Available at http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech509.pdf

[2] Kay Review launch speech available at http://www.bis.gov.uk/assets/biscore/business-law/docs/k/kay-review-napf-speech-sept-2011.pdf

Fig 1: Business Investment as a Percentage of GDP



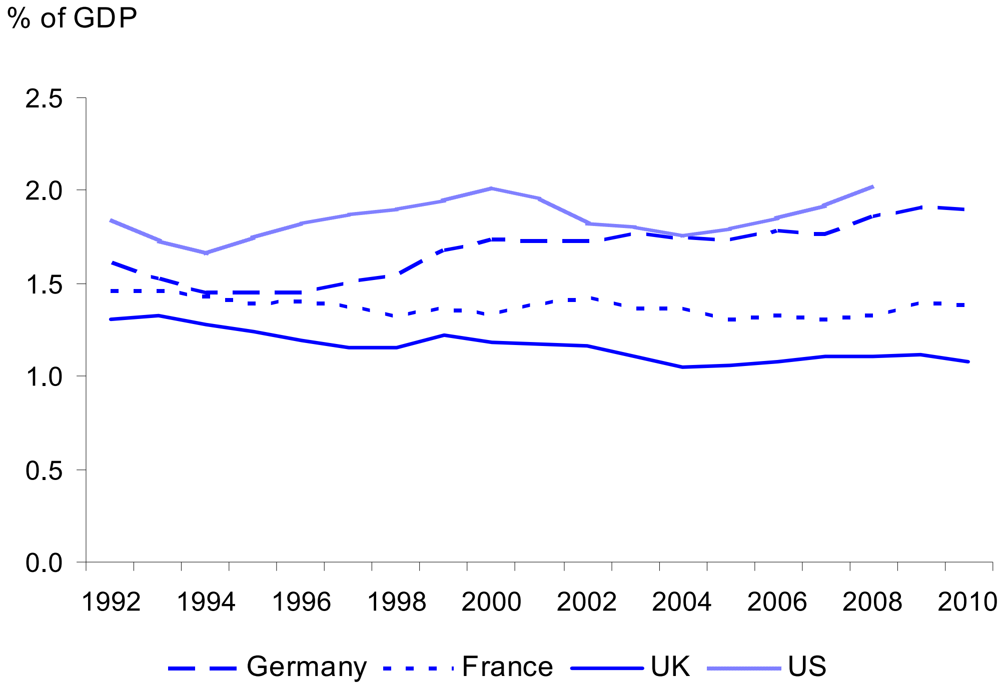
Source: Eurostat and US Bureau of Economic Analysis

1.7 Perhaps there were few good opportunities for British companies to invest – fewer opportunities than those available to their industry competitors based in other countries. The ability of companies to find profitable investments in tangible assets depends mainly on their earlier investment in intangible assets – the skills, capabilities, brands and reputations that are the source of competitive advantage for businesses and national economies.

1.8 It is not possible to measure such investment in establishing competitive advantage directly. Perhaps the best, although very imperfect, measure we have is expenditure on research and development. As a percentage of GDP, research and development expenditure by British business has been in steady decline. As is apparent from Figure 2, the UK invests a smaller percentage of its GDP in research and development than its principal trading competitors. This trend also long predates our current macroeconomic difficulties.

1.9 If our businesses are investing less than we might wish in their physical assets and their long-term capabilities, it is not because they are, collectively, short of cash. It is important to distinguish here between the relatively large companies which are, or might be publicly traded in London – the companies with which this Review is concerned – and the smaller businesses which are yet to establish their position in either the product market or the capital market.

Fig 2: Research and Development Investment as a Percentage of GDP



Source: Eurostat

1.10 There is a well founded concern that these smaller, mostly newer, businesses have found it particularly difficult to access the funding they need since the financial crisis. The government is taking a variety of measures to address this funding problem, but this subject, although important, is not the concern of the present Review. Quoted companies, both taken as a whole and in most individual cases, generate more cash from operations than they use for investment. They are not short of cash; they are awash with it. The value of the cash holdings of British business today is larger than the value of its plant and machinery.

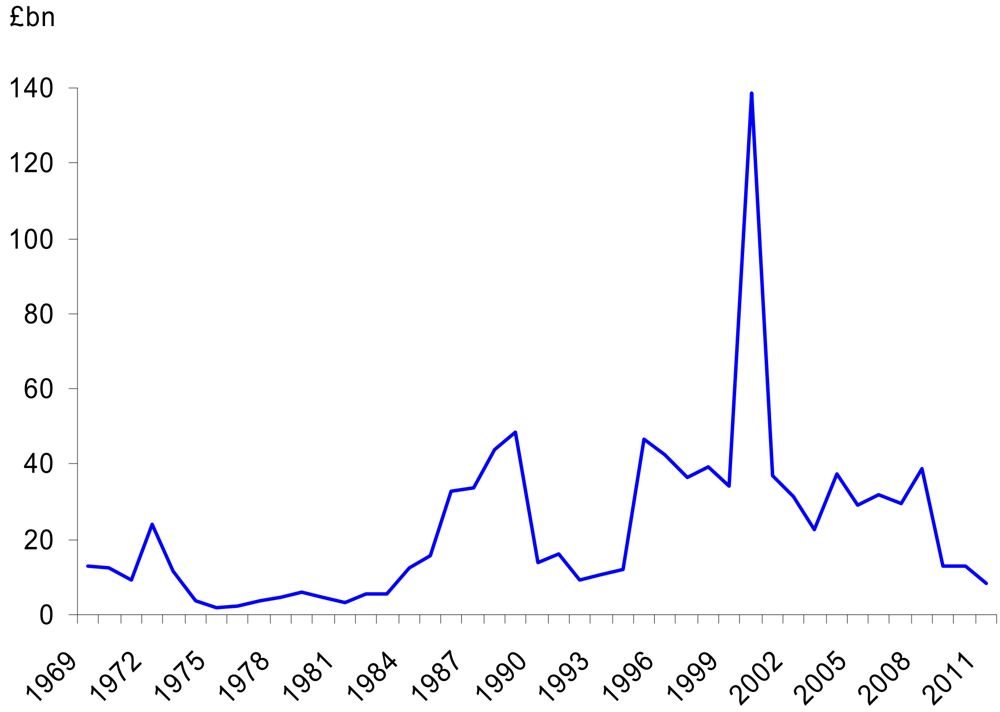
1.11 If there is some evidence here that British managers are less concerned with the long-term than their predecessors, or their competitors, there is also some evidence of hyperactivity. From time to time, the frenzy of the trading floor has been matched by the frenzy of the boardroom, as companies compete in the search for mergers and acquisitions (M&A). In the last two decades of the last century, there were periods of significant increases in M&A expenditures involving British companies (see Figure 3).

1.12 M&A activity is extremely cyclical – much more so than investment in physical assets. It reached a peak in the new economy bubble, declined thereafter, and then increased as confidence revived. There was a collapse during the credit crisis and expenditure on M&A remains at very low levels. Some commentators have visualised the cash hoard as a war chest to be raided when animal spirits return.

1.13 The growth of M&A activity is one aspect of the greater attention boards now give to financial market issues. Directors of UK companies have a statutory duty to promote the success of the company for the benefit of its members[3]. This formulation represents a codification of earlier case law on directors' obligations.

[3] NB: Directors have additional statutory duties to those set out here.

Fig 3: Mergers and Acquisitions by Value



Source: ONS
Notes: (i) Values are in real terms – base year 2011 (ii) 2000 M&A peaked at £138bn. It is likely this reflects the very large mergers of Vodafone / Mannesmann and Zeneca / Astra, (iii) The deal identification threshold was increased in 2010 from £0.1m to £1.0m and as a consequence there will be a discontinuity in the number of transactions reported.

This definition cannot be equated with a responsibility to maximise the current share price, although we received evidence that some company directors thought that it could. As a matter of law, as well as a matter of public interest, the primary responsibility of the board of a company is, through its senior management, to promote the success of the company and to do so over the long-term.

Companies Act 2006, Section 172

Duty to promote the success of the company

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

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

(b) the interests of the company's employees

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

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

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

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

1.14 We identified many cases in which poor decision-making had damaged the long-term success of the company. At the beginning of the 1990s, the two largest industrial companies in the UK were ICI and GEC. Neither of these companies currently exists in recognisable form, although parts of their former businesses continue under different ownership.

1.15 ICI had been established through mergers in the 1920s. As technology and customer demands changed, the company had shifted its business activities from its roots in dyestuffs and explosives to fertilisers and petrochemicals and finally to pharmaceuticals. The pharmaceutical division had been established after the Second World War and was unprofitable for almost two decades before the discovery of anti-hypertensive drugs gave the company a profitable product and sustainable market position. In the 1990s, ICI responded to stock market pressures by floating its pharmaceutical division and beginning a programme of business disposal and acquisition designed to re-establish the company as a speciality chemical business. The strategy was not successful and the company was acquired in 2007 by AkzoNobel. Britain does again have a major global chemical company, Ineos, although it is headquartered in Switzerland. It is privately owned.

1.16 GEC had become Britain's pre-eminent electrical company in the late 1960s through the acquisition of AEI and English Electric. Under the leadership of Lord Weinstock, the businesses were rationalised and substantial improvements were seen in productivity and profitability. In the latter stages of Lord Weinstock's tenure, however, the company was seen as excessively focussed on financial targets which resulted in an emphasis on sales in less competitive markets and GEC played little role in the development of new markets in consumer electronics and information technology. After Weinstock's retirement in 1996, the new executive team planned to reposition the company in growing markets by an aggressive programme of acquisitions and disposals. As at ICI, this programme was not successful. The share price collapsed and, after a major debt for equity swap, the company was broken up.

1.17 The history of both companies illustrates the financialisation of large UK corporations in the last decades of the twentieth century. Both companies reacted to weaknesses in their operating activities by trading in businesses rather than by trading in chemicals or electrical goods. Both were influenced in these decisions by external financial advice and by market perceptions of their activities as reflected in the rating of their stock.

1.18 In the two to three decades after the Second World War, the senior management of businesses such as ICI and the predecessor companies of GEC gave little attention to equity markets. Their activities were covered by analysts employed by stockbrokers, who were generally deferential and with whom they enjoyed distant relationships. The restructuring of the financial services industry that followed deregulation and internationalisation, the development of financing techniques which made possible the takeover of even the largest companies and the erosion of the traditional resistance of UK institutional investors to hostile takeover, all led major companies to pay far more attention to equity markets and their share price.

1.19 The norms of behaviour in the City of London were significantly affected by the pre-eminent role established by US investment banks, which favoured transactions and trading over relationships, and whose style was imitated by their European competitors. This cultural shift was associated with a rapid rise in share prices from 1982-2000[4]. Since 2000, however, this share price growth has not been maintained.

1.20 Before the era of such financialisation, companies like ICI regarded the maintenance of their position in the community as a natural corporate objective. Since the changes described above, it has become

[4] See, for example, Barclays' Equity and Gilt Study 2011 which reports an equity index for the UK based on the FTSE Actuaries All-Share index. Barclays' UK equity price index stood at 1,579 in 1982, had climbed to 12,329 by 2000 and was 12,655 at the end of 2010.

more necessary to remind companies of the wider obligations that corporate citizenship in the UK implies, through the formulation of ‘CSR’ and ‘ESG’ objectives. The long-run success of British business depends both on the relationships that companies enjoy with their stakeholders, broadly defined, and on the legitimacy and sustainability of the market economy in which they operate.

1.21 The financialisation of senior management concerns affected many companies, and in different ways. At the beginning of the 1990s Marks and Spencer enjoyed an iconic reputation in the UK and internationally. The company pursued policies which increased its margins and squeezed its – historically predominantly British – supplier base. This strategy initially proved successful; but in 1998 – after the company had reported record annual profits of over £1 bn – sales fell and profits fell more dramatically. The business has never regained the level of profitability achieved then.

1.22 BP became at this time one of Britain’s most admired companies, playing a major role in the consolidation of the global oil industry[5]. After the millennium, however, it became apparent that pressure on costs had led the company to devote insufficient attention to environmental and health and safety issues. A series of incidents followed, principally in North America. Accidents at Prudhoe Bay and Texas City were followed by the blow-out in the Gulf of Mexico which inflicted major financial and reputational damage on the company.

1.23 In 2008, Royal Bank of Scotland (RBS) and Halifax Bank of Scotland (HBOS), two of Britain’s major banks, collapsed and were rescued by substantial injections of taxpayer funding. None of the building societies which converted to public companies, after such conversion was permitted in the 1986 Act, now survive as independent businesses; two were taken into public ownership. The failures of governance at banks have been investigated in a report by Sir David Walker[6]. These failed banks were characterised by acute short-termism and serious hyperactivity.

1.24 These examples illustrate the variety of ways in which short-term thinking can lead to bad long-term business decisions. Companies may not invest sufficiently, especially when the costs of such investment must in part or in whole be charged to current profits, as with expenditure to maintain a good safety record or reputation with customers for value for money. Companies may, for very similar reasons, focus on marketing established products rather than developing new ones. And they may then seek to compensate for these weaknesses by frequent reorganisation of the portfolio of businesses the company owns. Such behaviours damage the company’s market position and reduce its value in the longer term.

1.25 We do not wish to give a negative impression of the performance of British business, or Britain’s quoted companies, as a whole. A number of companies have performed well during these decades. Although BP made insufficient investment in its reputation, its performance in identifying and exploiting new long-term sources of supply has been impressive. Rolls Royce is the only major non-American supplier of aircraft engines to an expanding global marketplace, thanks to its long-term approach. ARM is a world leader in the design of energy-efficient microprocessors used in a wide range of smartphones, tablets and other portable electronic devices worldwide. Several smaller manufacturing companies such as Senior, Weir Group and Renold enjoy a similarly impressive position in their sector. Tesco has developed into the UK’s largest retailer with operations around the world. Vodafone, which began operations only in the 1980s, is now the largest mobile phone operator globally.

[5] Apart from the merging of BP with Amoco and its acquisition of ARCO and Burmah Castrol, other mergers between large oil companies include Exxon and Mobil and Chevron’s acquisition of Texaco.

[6] The key recommendations of the Walker Review are available at http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf

1.26 In the 1970s, Glaxo made a successful long-term investment in the development and promotion of Zantac which created a British world leader in pharmaceuticals. In the 1990s, however, the company – in common with other global pharmaceutical companies – appears to have given relatively too much attention to marketing and to the acquisition of other pharmaceutical businesses, and not enough to the fundamental research on which long-term success in this industry depends. The long-term damage resulting from such misdirection was exemplified in the $3bn fine imposed by the US regulatory authorities as this report went to press. More recent changes in strategy at GSK have sought to address this strategic imbalance. Similar problems have caused concern at AstraZeneca, the other major British pharmaceutical company (and, in a sense, the successor company to ICI) where the failure of the company to develop a strong pipeline of new drugs recently led to the resignation of the chief executive.

1.27 The experience described above is mixed. Some bad long-term decisions would be made in any institutional structure. But while ICI and GEC have disappeared, their German competitors BASF and Siemens are now respectively the leading chemical and engineering companies in the world. The failure of some companies and the rise of others are central to the dynamic of a market economy. But where are Britain's Amazons, Apples or Googles? Autonomy, perhaps Britain's most successful company in this sector, was acquired by the US information technology firm Hewlett-Packard in 2011: the outcome has not been a happy one for either company. Why has no new British business emerged to take the place of the financial institutions which failed in the recent crisis? There are sufficient issues about the performance of large British quoted companies over the last two decades to raise questions about the role of equity markets in encouraging high performing businesses.

1.28 Many of the responses to our call for evidence[7] took the view that the central problem of relationships between companies and their shareholders was that there was insufficient accountability of companies to shareholders and that shareholders were insufficiently engaged. The corporate histories we outline above suggest a different view. Many of the bad decisions described were supported or even encouraged by a majority of the company's shareholders.

1.29 The proposed transformation of GEC, for example, was enthusiastically received in equity markets and the company's share price soared before it finally collapsed. BP's drive on costs was strongly supported by analysts. The acquisition of ABN Amro by RBS was overwhelmingly endorsed in a shareholder vote even after the credit crunch had begun to bite. The explosive growth of Northern Rock was also welcomed by many analysts and led to a steady increase in the company's market capitalisation. In all these cases, however, the behaviour of the share price in the months before problems were publicly recognised suggests that some shareholders may have recognised more quickly than management that mistakes had been made.

1.30 The issue that concerns us is not whether there is too much or too little shareholder engagement. It is whether the messages that managers and shareholders convey to each other, at meetings and through the share price, provide a framework within which companies and their boards can make balanced assessments of the measures needed to promote the success of the company in the long-run. Shareholder engagement is neither good nor bad in itself: it is the character and quality of that engagement that matters.

1.31 Meetings and the share price are the two mechanisms through which management and shareholders communicate. The distinction between these two mechanisms corresponds to the economist Albert Hirschman's famous distinction between the courses of action available to buyers when the quality of a relationship is inadequate: 'voice' – attempting to improve outcomes within the context of the market

[7] The responses to the September 2011 call for evidence are available at http://www.bis.gov.uk/policies/business-law/corporate-governance/kay-review/kay-review-responses

relationship; and ‘exit’ – withdrawal from the market relationship[8]. These alternatives apply just as much to a shareholder concerned with corporate governance or company performance as to a customer dissatisfied with the produce at the local supermarket. The unhappy shopper can complain to the management, or go elsewhere. And so can the contemporary shareholder.

1.32 There is, however, an important difference between the two cases. The unhappy shareholder exits only by finding someone else to take his or her place. This substitution does not eliminate the impact of exit, but it greatly reduces it. At the same time, the structure and regulation of equity markets today overwhelmingly emphasise exit over voice and this has often led to shareholder engagement of superficial character and low quality. We believe equity markets will function more effectively if there are more trust relationships which are based on voice and fewer trading relationships emphasising exit.

[8] Hirschman, A. (1970), Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States, Harvard University Press.

2 Equity markets & listed companies

2.1 Equity markets are a means of financial intermediation between savers and companies. Financial intermediation enables savers to achieve diversification and liquidity. Effective intermediation reduces risk and permits the time horizons of savers to differ from the time horizons of companies.

2.2 The price of diversification and liquidity is a loss of information and control. Shareholders who own stocks in many companies will necessarily be less familiar with the activities and performance of each company in their portfolio. Shareholders provided with liquidity have reduced incentive to engage with the companies in which their funds are invested: there is less need for voice when exit is available.

2.3 An effective intermediary, or process of intermediation, provides diversification and liquidity to savers: and a skilled and trusted intermediary will minimise the loss of information and control which come from a more fragmented and distant relationship with companies. But intermediation raises new issues of its own: capable and knowledgeable intermediation will be costly, and savers who employ intermediaries place their funds in the hands of managers whose interests may not be aligned with their own.

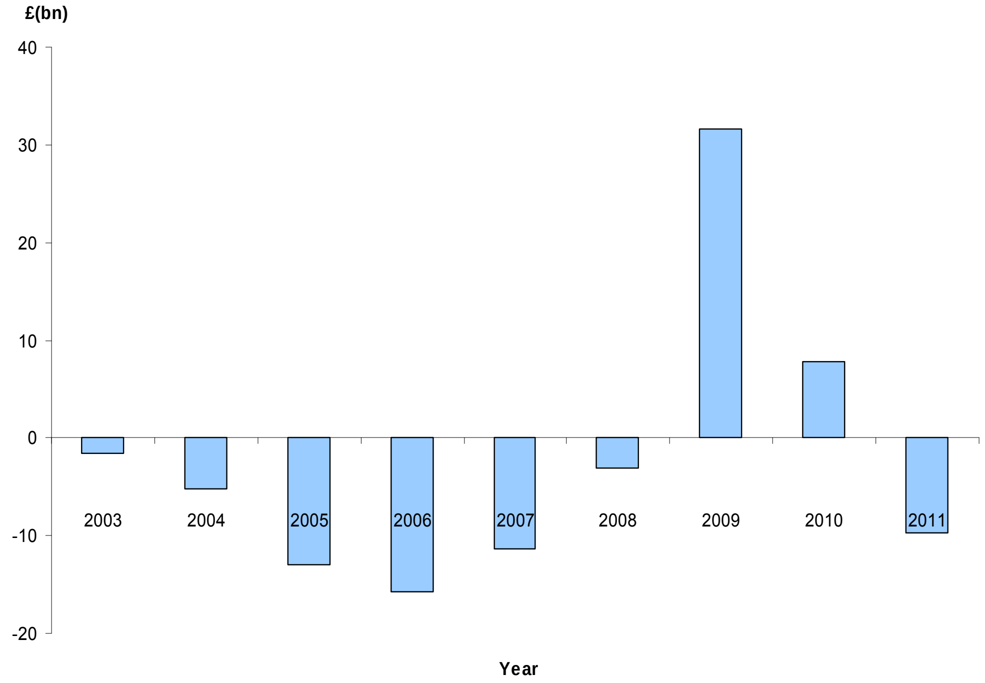
2.4 Successful financial intermediation is therefore a means by which the expertise of the intermediary enables savers to derive the benefits of diversification and liquidity while minimising the disadvantages resulting from the loss of information and control inevitable in more distant and fragmented relationships. The problems resulting from imperfect knowledge and the divorce of ownership and control are generally described by economists as problems of information asymmetry and principal–agent relationships, and since the consequences of these problems are central to an understanding of the role and development of equity markets we will make use of this language.

2.5 Information asymmetry and principal-agent conflict become steadily more serious as the modern corporate economy evolves. As companies grow in complexity, shareholders necessarily know less about the businesses in which their funds are invested: as companies become larger and shareholding more fragmented, relationships between savers and the management of the companies in which their funds are invested become more distant and the potential for their interests to diverge is increased.

2.6 Equity markets have not been an important source of capital for new investment in British business for many years. Large UK companies are self-financing – the cash flow they obtain from operations through profits and depreciation is more than sufficient for their investment needs. This is true of the quoted company sector as a whole and of a large majority of companies within it.

2.7 Finance raised through placings and rights issues by established companies, and initial public offerings (IPOs) by new companies, have generally been more than offset by the acquisition of shares for cash in takeovers and through share buyback (see Figure 4). New equity issuance has therefore been negative over the last decade.

Fig 4: Net equity issuance by PNFCs[9]



Source: Bank of England

2.8 The 2009 peak was almost entirely accounted for by companies that had previously raised equity, as opposed to first-time equity issuers. According to the Bank of England, the primary reason behind this increased equity issuance was to reduce leverage rather than finance new projects.[10] The largest share issues by established UK companies in recent years were made by banks and financial institutions. These companies were required by their regulators to raise fresh equity capital to fund past losses and meet more stringent capital requirements. The UK government was the principal provider of such capital.

2.9 There have also been some very substantial issues by companies which have little or no connection with UK business: the biggest IPOs in London in the last decade have been those of Rosneft (the Russian oil and gas producer) in 2006 and of Glencore (a Swiss based commodity trader) in 2011. Apart from refinancing by banks and other financial companies (notably heavily indebted real estate companies whose asset positions deteriorated after 2007) rights issues by established large UK companies are rare. In 2009 RTZ raised $15.2 bn in London and Australia to refinance its acquisition of Alcan after a projected Chinese partnership was aborted. The £3.2 bn rights issue by National Grid in 2010 is by far the largest instance of the use of UK equity markets to raise funds for new investment in British business.

2.10 The IPO market is used by smaller companies to raise funds, but more importantly to provide liquidity for early stage investors. There have been few IPOs by companies operating in Britain since the financial

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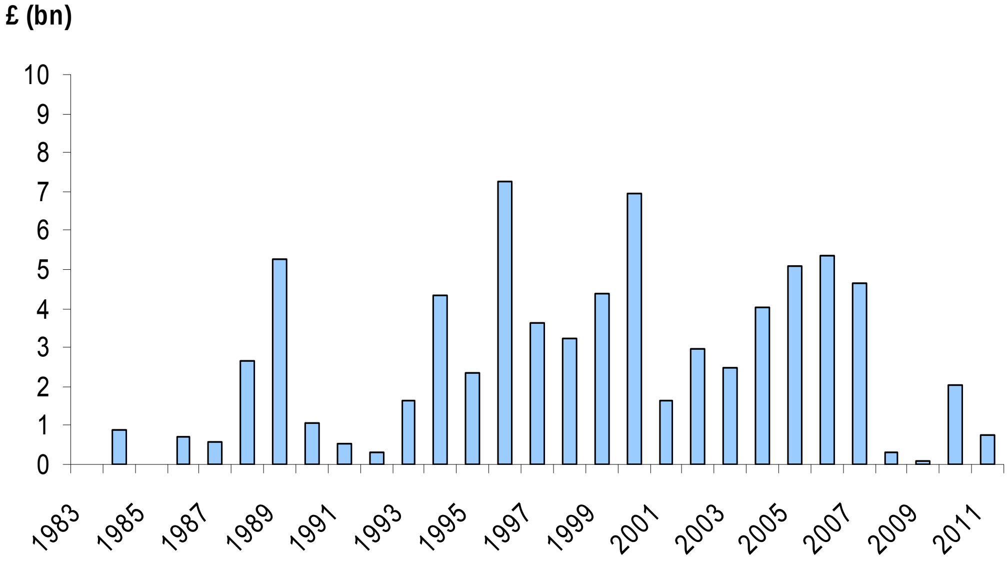
[9] Note: Private Non-Financial Companies are comprised of Limited, unlimited, chartered, statutory and other *corporate* bodies ***incorporated in the mainland*** of Great Britain and Northern Ireland which are not classified as financial corporations, public corporations, or within central government or local government. This excludes both banks and insurance companies.

[10] Pattani, Aashish; Vera, Giuseppe; and Wackett, James; Going Public: UK Companies' use of Capital Markets in *Bank of England Research and Analysis UK Companies' use* of *Capital Markets (3 April 2011) at:* http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb110403.pdf

crisis of 2007-8 (see Figure 5). Respondents to the Review talked of a 'buyers' strike': institutions have become disenchanted with the poor quality and high price of new issues. We were told that a public offering was now rarely the exit route of choice for investors in smaller companies, who were more likely to look for a trade sale or secondary participation. It is unusual for a large listed company divesting a subsidiary to seek a flotation: sale to another company, or a buy out financed by debt, often with the aid of private equity, is the preferred route.

Fig 5: Value of IPOs by PNFCs



Source: Dealogic

2.11 Acquisitions have steadily reduced the number of publicly traded companies[11]; some acquisitions of quoted companies have the express purpose of taking the business private. Obtaining a listing is no longer a natural step in the development of a new business. As a result, the number of publicly traded companies (i.e. Main Market plus AIM) has fallen steadily[12] (see Figure 6).

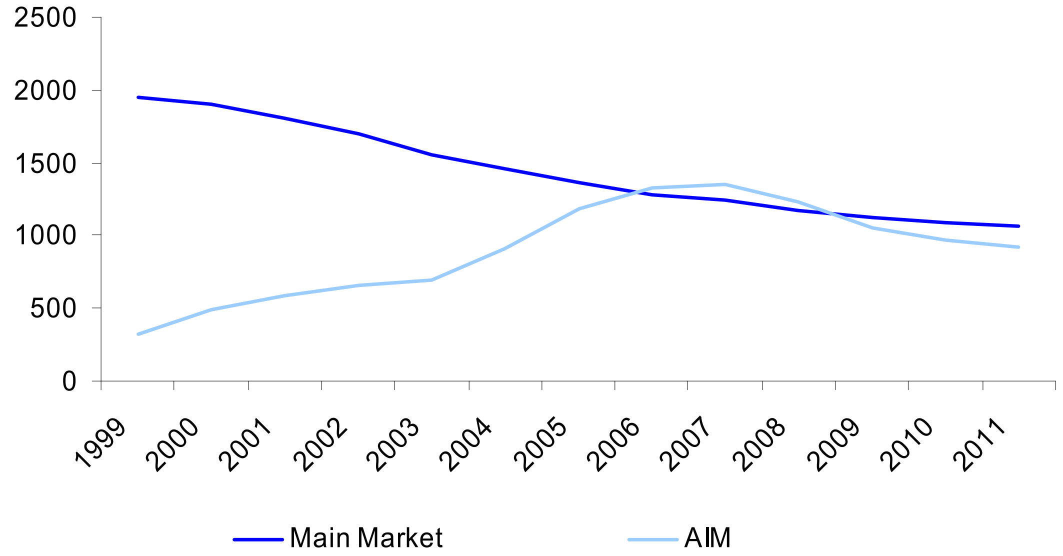
2.12 There are many reasons for the decline in the role of equity issues in investment. In a modern economy, investment in physical capital is much less important than it was. Primary issuance in public equity markets in the US has also declined, although not to the extent seen in the UK. But the most successful of 'new' businesses – companies such as Apple and Google – raised only small amounts of equity on public markets and accumulated large amounts of cash within a few years of starting operations. The prospectus of the recent IPO of Facebook stated explicitly that "we do not currently have any specific uses for the net proceeds planned".

2.13 Britain's largest 'new' company – Vodafone – has a much more capital intensive business than these information technology companies but it has financed that investment through debt and retained earnings rather than from equity markets, although it has issued very large amounts of its equity in the course of its acquisitions of the equity of other businesses. Even companies in sectors that have large

[11] The number of mergers and acquisitions in the UK by UK companies increased steadily in the run up to the crisis, peaking at 869 in 2007 from 492 in 2001, then falling back under 400 in 2011. *Source: ONS mergers and acquisitions data tables. See www.ons.gov.uk for downloads.*

[12] See LSE data available at http://www.londonstockexchange.com/statistics/historic/company-files/company-files.htm

Fig 6: Total UK Publicly Traded Companies



Source: LSE

capital requirements – such as oil and utilities – make little or no use of primary equity markets, relying instead on debt and internal funding. The National Grid issue described above is a conspicuous exception and one that was reported as being controversial with investors.

2.14 The diminished importance of public equity markets as a source of new funds for business investment has been paralleled by a rise in private equity and in the use of corporate debt. Both private equity and debt generally imply direct engagement with companies of a kind which is made more difficult by the fragmented ownership characteristic of equity markets and the extensive regulation of information provision by listed companies.

2.15 Many respondents blamed the long established tax discrimination between debt and equity for the decline of equity markets. Others were critical of the regulatory changes governing insurance companies and pension funds which had reduced the supply of funds for equity investment.

2.16 We were told that savers may have become disenchanted with equity investment as a result of a decade of disappointing performance. As at 30 June 2011, the total return on the FTSE all-share index over the last five years has been 4.5% per annum and over the past ten years 4.8% per annum[13].

2.17 Listing has become more burdensome, and expensive. The establishment of the AIM market was an attempt to encourage smaller companies to use public markets by imposing less demanding obligations, and was successful for a time: but in the last five years the number of AIM companies has also declined[14].

2.18 Although we believe there is an element of truth in all these explanations, we do not find them adequate to account for the dearth of primary equity issues. We believe the fundamental reasons go deeper, and reflect the nature of financial intermediation itself.

[13] See http://www.ftse.com/Indices/UK_Indices/Downloads/FTSE_All-Share_Index_Factsheet.pdf

[14] The number of companies listed on AIM at June 2012 was 891. In June 2007 this figure stood at 1,337.

2.19 Many respondents referred to the cost of equity capital and, although there were few specific measures of this cost, there was wide agreement that the cost of equity capital to companies was today high by historical standards and in absolute terms. Expected returns to equity investment for savers, however, do not appear to be abnormally high either by historical standards or in absolute terms. The modest expectations of investors can be seen in the numbers used in actuarial valuation and portfolio allocation models, and is evidenced by declining allocations to equities in portfolios even in the face of unprecedentedly low rates of interest and yields on secure bonds[15].

2.20 There are two possible explanations of the apparent divergence between the anticipated costs to companies and the anticipated yields to savers. One is the size of the wedge driven between the earnings of companies and the returns to savers by the costs of intermediation in both primary and secondary markets. The second explanation is that companies' expectations of the quantum of future earnings they will have to allocate to meet the needs of prospective new shareholders – their view of the cost of capital – differ substantially from the perceptions of these prospective shareholders of the likely value of these earnings to them – their view of the return on capital.

2.21 The first of these issues – the rising cost of intermediation – is discussed further later in this report. The second issue – the divergent perceptions of issuing companies and investing savers – is the product of the increased distance between companies and savers which results from the lengthening of the chain of intermediation, and of the growth in the complexity of the modern corporation.

2.22 In markets where there are differences in the expectations of buyers and sellers there will be little trade, and that trade will principally come from forced sellers or relate to goods of poor quality. This is the market failure famously described by George Akerlof in his seminal description of the 'market for lemons'. That model describes the recent experience of the UK primary issue market. The most important recent development in UK equity markets has been the simultaneous decline in new issuance by UK companies and growth in secondary market trading in existing securities of UK companies.

2.23 The divergence of company and shareholder expectation is powerfully illustrated by the principal industry which has recently raised substantial quantities of new equity – the banking sector. In various submissions, banking companies have claimed that their cost of equity capital is in the region of 15%. Even allowing for some exaggeration in this figure, if investors really expected a return of 15% per annum from investment in banks they would rush at the opportunity. Yet it has been difficult for many European banks to raise any new equity capital at all from markets except, as in the recent rights issue by Unicredit, on terms so onerous that the effect was virtually to wipe out the value of existing shareholders' equity. While, as noted above, UK domiciled banks did raise significant capital from private investors, most of the funds for the recapitalisation of the British and European banking sector have come from governments and from retained earnings.

2.24 There is evidently a wide gap between what banks expect to pay for new equity and what savers expect to receive from such an investment. This gulf in expectations results from information asymmetry and principal-agent problems: prospective investors have little confidence either that they understand the accounting statements of banks or that incentives and objectives of senior executives of banks are aligned with their own. Given the experience of 2007-8, such caution is understandable.

2.25 The banking sector illustrates in extreme form the problems of imperfect information and incentive misalignment in equity markets. These issues are not new. As corporations became larger and more

[15] See the IMA survey "Asset Management in the UK 2010-2011" on the declining allocation of funds to UK equity, whereas 2012 has seen the yield on 10 year gilts fall well below 2%.

complex in the early part of the twentieth century, information asymmetry and principal-agent issues provided scope for corporate malpractice and corrupt stock promotion. Abuses became particularly widespread in the US in the 1920s. Some similar developments happened at that time in the UK. Lord Kylsant, politician and chairman of the Royal Mail Steam Packet Company, a major British shipping company of the time, was jailed in 1931 after being held responsible for a false prospectus issued by the company.

2.26 In the US such abuses were addressed in the 1930s through the development of extensive securities regulation. The core principles of such regulation were that templates should be prescribed for the presentation of company information and that the provision of information outside these templates should be restricted. As markets became more international, and regulation in other countries more extensive, these principles were imitated in Britain and more recently in other European countries.

2.27 The regulatory framework developed in the US in the 1930s also attempted to mitigate principal-agent problems. The primary means of limiting opportunities for conflicts of interest was to require specialisation of financial intermediaries. Separation of functions was already the practice in the UK, and in both Britain and the US primary securities issuance was separated from market making and secondary trading, although universal banking was common in major European states. These restrictions were mostly dismantled in the deregulation enacted in the US and UK from the 1970s through to the 1990s. At the same time, the internationalisation of financial markets brought US investment banks to London, and in the restructuring of the industry which followed deregulation these banks became a principal force. Major European financial institutions transformed themselves into financial conglomerates on an American model.

2.28 The result of all these changes – a regulatory perspective based on equality of information and the growth of diversified financial institutions whose culture was derived from the US or developed in imitation of US practice – was the rise of an ethos which emphasised transactions and trading over relationships. This ethos permeated all areas of the financial services industry. As described in Chapter 1, the shift from relationship to trading, from voice to exit, came to affect not only the interaction between shareholders and companies but between corporate executives and their companies: some managers came to see themselves as traders, engaged in the management of a portfolio of businesses to which they owed no particular attachment.

2.29 This approach differs materially from European tradition in financial markets and corporate management. The City of London historically emphasised relationships of trust and confidence. Concentrated share stakes held by families or financial institutions have been, and still are, common practice in continental Europe. The change in the nature of European financial services which has occurred in the last three decades has been driven largely by American practice and American thinking.

2.30 The measures implemented in the US in the 1930s were a pragmatic response to specific abuses, in which companies issued misleading information and financial intermediaries used their superior knowledge and exploited conflicts of interest to sell inappropriate products to their customers. In time, however, the principles underlying the regulation of securities markets came to acquire a philosophical underpinning. That underpinning came from an economic theory which suggested that if securities markets were supplied with sufficient information, and all participants traded on the basis of that information and only that information, then not only would problems of information asymmetry and incentive misalignment be relieved but savers, intermediaries and corporate executives would collectively make decisions which maximised the long-term returns earned by companies.

2.31 We discuss in Chapter 4 why people might have supposed this theory was true. The central observations of this chapter and the previous one – that companies have made bad long-term decisions in response to capital market pressures and that new equity finance is not currently available to companies on terms on which many of them wish to raise it – suggest reason for some scepticism about whether it is true.

2.32 Equity markets today should primarily be seen as a means of getting money out of companies rather than a means of putting it in. This does not mean that equity markets are not relevant to investment in UK business. But the relevance is indirect. Equity markets are one of the means by which investors who support fledgling companies can hope to realise value. Equity markets provide a means of oversight of the principal mechanism of capital allocation, which takes place within companies. Promoting stewardship and good corporate governance is not an incidental function of equity markets. The effectiveness of modern equity markets depends almost entirely on their effectiveness in promoting these goals of stewardship and governance.

2.33 It is important to emphasise that we are not arguing that policymakers should cease to consider that ensuring that equity markets remain an attractive means of obtaining funding to be a legitimate policy objective. On the contrary we suggest that this should continue to be a central consideration in the listings regime and more widely. Indeed, in Chapter 12 we argue that Government and regulatory policy should aim to ensure there are no unnecessary disincentives to using equity markets, either for companies or for their investors. And we believe that our recommendations to encourage asset managers to act as long-term stewards of more concentrated, less liquid equity portfolios will mean a greater willingness to invest funds across a broader range of companies, including smaller businesses who wish to raise equity finance, but are currently unable to do so.

3 The structure of shareholding

3.1 Fifty years ago, most shares in UK companies were owned by individuals, who dealt through stockbrokers, at fixed – and high – rates of commission. The stockbroker would often know his client personally, and would often also be directly acquainted with the companies whose shares he recommended. Much stock exchange activity had a character that would today be regarded as insider dealing.

3.2 Both life insurance companies and pension funds traditionally placed funds principally in fixed interest securities, both government and corporate, and secondarily in property. From the 1960s, these institutions substantially increased their equity exposure. At the same time, the coverage of occupational pension schemes among UK employees was greatly extended. By the 1990s, UK insurance companies and pension funds were the most important holders of UK equities, accounting for around half of the total (see Table 1).

3.3 More recently, regulation of pension and life funds, and the maturity of pension funds, has led both pension trustees and insurers to reduce their exposure to equity markets[16]. The size of the funds themselves has diminished as a share of total UK financial assets. Many insurers and pension funds have outsourced their investment to specialist asset managers. In some cases these specialists are spin offs from the sponsoring insurance company or pension fund. The insurer or pension fund encourages the divested business to seek external customers. The globalisation of financial markets has encouraged UK equity investors to hold more overseas equities, and a corollary is that many more UK equities are now held by foreign institutions. Sovereign wealth funds have become a significant global investment force, holding around $5 trn in assets globally[17].

3.4 The result of all these changes is a further evolution in the structure of the UK equity market. Holdings by pension funds and insurance companies now account for around 20% of the total (see Figure 7); the share attributed to non-UK holders is over 40%. The pattern of shareholding is much more fragmented than formerly.

3.5 Individual shareholders (including individuals who hold through nominee accounts) now own around 11% of UK equities. The steady decline in direct ownership of shares by small investors has recently been offset by a rise in the proportion held by employees and (increasingly) directors.

3.6 When individual shareholding was the norm, shareholders would receive communications directly from the companies in which they invested. With the introduction of electronic trading in the 1990s, retail investors were encouraged to hold shares in nominee accounts maintained by the principal banks and private client stockbrokers.

[16] See the IMA surveys on Asset Management in the UK for analysis of the reduced equity exposure in the institutional market.

[17] See "Sovereign Wealth Funds", published by TheCityUK, February 2012.

3.7 The decline in the role of the individual shareholder has been paralleled by an explosion of intermediation. Between the company and the saver are now interposed registrars, nominees, custodians, asset managers, managers who allocate funds to specialist asset managers, trustees, investment consultants, agents who 'wrap' products, retail platforms, distributors and independent financial advisers. Each of these agents must employ its own compliance staff to monitor consistency with regulation, must use the services of its own auditors and lawyers and earn sufficient to remunerate the employees and reward its own investors.

3.8 Some of this rise in the number of intermediaries – for example, the administration of a company's share register by a professional registrar – is the result of a general trend to outsource corporate functions to specialists: a trend which extends far beyond the financial sector. Specialists can develop appropriate skills, derive economies of scale, and make full use of modern information technology. Some of the growth of intermediation has been driven by regulation, and some by a market driven search for greater professionalism.

3.9 But a principal driver of the growth of intermediation has been the decline of trust and confidence in the investment chain. The role of custodian came into being because the asset manager could not be trusted to hold shares on behalf of the ultimate shareholder. Pension fund trustees have been required to supervise more closely the activities for which they are responsible, a result of some well publicised demonstrations that certain intermediaries could not, in fact, be trusted. Trustees are also expected to employ intermediaries to assist in the task. As confidence becomes eroded, such proliferation is inevitable: the question of who guards the guards is inevitably followed by the question of who guards the guards who guard the guards.

3.10 Whether the reasons for the proliferation of intermediation and intermediaries are good or bad, such proliferation adds to the costs of the investment chain, and creates potential for misalignment of incentives at each link of the chain. The imperatives of the business model of the agent do not necessarily coincide with the interests of the ultimate principals – the companies which use equity markets and the savers who provide funds to them.

3.11 A by-product of the growth of intermediation has been a tendency to view the performance of the market through the eyes of intermediaries. Many respondents to the Review observed this trend in the direction and conduct of regulation. Other respondents simply thought it natural to view the market in this way. Goals such as liquidity, transparency, and price discovery have come to be regarded as ends in themselves, not as intermediate steps towards the underlying objectives of high performing companies and good returns for savers.

3.12 The term "share ownership" is often used, but the word "ownership" must be used with care. It is necessary to distinguish:

- Whose name is on the share register? (often a nominee)
- For whose benefit are the shares held? (e.g. a pension fund trustee)
- Who makes the decision to buy or hold a particular stock? (normally an asset manager)
- Who effectively determines how the votes associated with a shareholding should be cast? (this might be an asset manager, a pension fund trustee, or a specialist proxy voting service); and
- Who holds the economic interest in the security? (i.e. who is the saver who bears the gains and losses from investment?)

Table 1: Historical Trends in Beneficial Ownership (Percentage Held)

	1963	1975	1981	1991	2001	2008	2010
Rest of the world	7	5.6	3.6	12.8	35.7	41.5	41.2
Insurance companies	10	15.9	20.5	20.8	20	13.4	8.6
Pension funds	6.4	16.8	26.7	31.3	16.1	12.8	5.1
Individuals	54	37.5	28.2	19.9	14.8	10.2	11.5
Other	22.6	24.2	21	15.2	13.4	22.1	33.6

Source: ONS
Note: i) ONS data for 2010 is not directly comparable with that of previous years due to a change in methodology. ii) Whilst the Rest of the World category represents a large proportion of the population, there is no identification of those holders who have traditionally been UK based but taken over by foreign competitors, yet remain based in the UK. For example, Blackrock's takeover of BGI would reclassify this asset manager as a foreign owner.

3.13 It is possible, and in fact common, for each of these rights of ownership to be held by different people. The position is further complicated by the practice of stock lending, in which shares are 'lent" to enable a short seller to demonstrate his capacity to fulfil his commitments. In the light of this complexity and potential ambiguity, this Review will avoid wherever possible using the term share ownership. We will use the term 'saver' or 'beneficiary' to describe the person whose money it is, who holds the economic interest, and who will be the ultimate beneficiary of successful investment. From the perspective of the company and its decision-making, the key rights associated with shareholding are discretion to buy or sell the share and authority to decide how the share should be voted. These aspects of shareholding correspond to the exercise of right of "exit" and right of "voice". The asset manager today typically plays a key role in the exercise of both these rights.

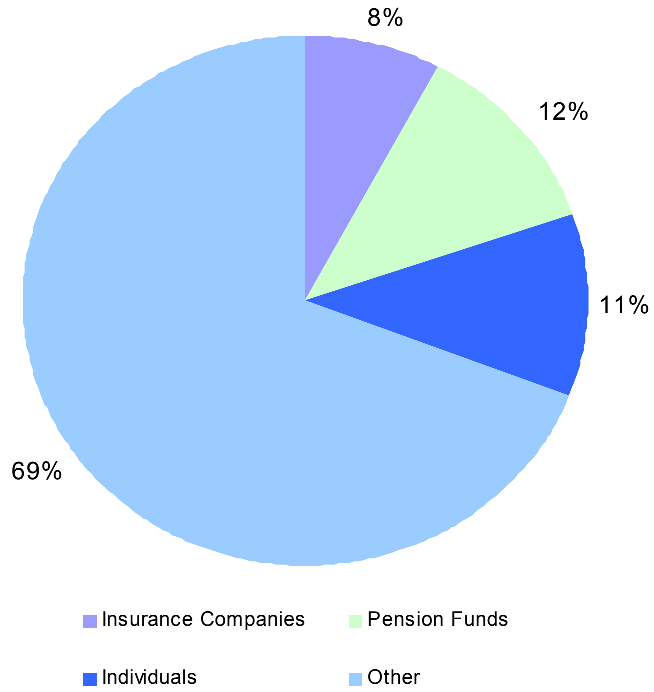
3.14 Because of this ambiguity in the meaning of ownership, data such as that presented in Table 1 should be treated with care. We have been provided with analysis by Cass Business School (see figure 7) which attempts to investigate further the links in the equity investment chain. This more recent data, though not directly comparable with that of the ONS, also demonstrates the current low level of individual ownership of UK equities.

3.15 The two intermediaries of most importance to us will be the asset manager – who makes buy and sell decisions – and the asset holder. By the term asset holder we refer to agents – such as pension fund trustees and insurance companies which have delegated responsibility for asset management – who may hold legal title to the shares but do so as agents for savers who enjoy the economic interest.

3.16 The figure for foreign 'ownership' is exaggerated since it includes holdings by asset managers whose parent company is US based even though management is conducted from the UK and the manager may be acting on behalf of UK clients. BlackRock, a US firm, is today the largest asset manager in the UK equity market[18]. Other US asset management firms such as Capital, Fidelity and Vanguard have substantial London offices.

[18] BlackRock's total UK assets under management amounted to £530bn at the end of 2010.

Fig 7: FTSE 100 Ownership by Beneficial Owner Type (percentage of total value)



Source: CASS Business School
Note: CASS data is not directly comparable with that of the ONS Beneficial Ownership Survey due to methodological differences.
The 'Other' Category includes: charities, financials, governments, hedge funds, investment funds, investment trusts, company holdings, unclassified funds.

3.17 The holdings of these asset managers in UK companies are principally run from London. Major sovereign wealth funds also have London offices. London is the world's largest centre for asset management (although if funds managed from Boston and San Francisco are added to those of New York, the total of funds under management in the United States is greater). Investment in UK business is a relatively small part of that total of funds under management. It is, however, the part of greatest significance for the economic performance of the UK. The dominant players in the equity investment chain today are professional asset managers, and the dominant players in UK equity markets are London based asset managers.

4 Market efficiency: economic issues

4.1 The efficient market hypothesis has been a cornerstone of financial economics for two generations. Broadly speaking, this theory asserts that markets are ‘efficient’ , meaning that publicly available information is reflected in market prices. In that weak form, this theory is uncontroversial.

4.2 The term ‘market efficiency’ is used by proponents of the efficient market hypothesis in this specific, technical sense, which relates to information and securities prices. The term ‘market efficiency’ can also be used in a broader context to refer to the advantages of a market system over central planning as a means of resource allocation. Yet another, but much narrower, meaning of market efficiency is concerned with the effectiveness of the mechanics of securities trading. This latter concept of ‘market efficiency’ is concerned with the technical functioning of the relevant markets. These three uses of the phrase are distinct, and none of these concepts of market efficiency implies or is implied by the others. The loose use of the word ‘efficiency’ in relation to securities markets causes considerable confusion.

4.3 The efficient market hypothesis has been elaborated beyond the compelling proposition that information feeds into prices. Such extension (sometimes called the strong efficient market hypothesis) is based on a number of additional assumptions and is closely associated with the capital asset pricing model (CAPM) which is central to much financial analysis. The framework is one in which all potentially knowable information is known to all market participants, or at least market participants act as if this were so. These market participants behave ‘rationally’, in a particular sense of rationality which requires a certain consistency of behaviour and implies a probabilistic approach to thinking about risk. This concept of ‘rationality’ is transmitted without distortion down the investment chain so that everyone from financial adviser to company director behaves in line with the ‘rational’ self-interest of the underlying beneficiaries.

4.4 If these assumptions hold, then the market price may be an unbiased estimate of the fundamental value of a security. In the context of share valuation, that fundamental value would reflect the anticipated earnings and cash flow of the company which issued the shares.

4.5 For most quoted companies, the fundamental value assessed in this way is speculative and most of it lies far into the future. For a representative company with a price earnings ratio of 15, for example, around two thirds of the current fundamental value of the company would be derived from earnings which would arise more than five years ahead.

4.6 This observation might be interpreted as evidence that the equity market does indeed take account of long-term expectations, and there is certainly truth in that claim. But events such as the new economy bubble of 1999-2000 suggest a more nuanced view. The prices shares commanded in that period certainly appeared to discount earnings in the distant future – in fact they discounted earnings which seemed unlikely to materialise on any reasonable time scale. But most holders were not expecting to retain these shares for extended periods in order to receive cash flow from mature businesses. They hoped to be able to pass the shares on quickly to someone else at a higher price. Bubbles such as occurred during the new economy speculation are an extreme illustration of the potential for divergence between stock prices and fundamental value which occurs when ill-founded beliefs gain wide credence or when gambling, amateur and professional, becomes the principal determinant of market prices.

4.7 The level of abstraction of theories such as the strong efficient market hypothesis and capital asset pricing model is high: but their practical influence appears to be considerable, even among people who express general scepticism about this kind of reasoning. Some practitioners to whom we talked displayed an almost mystical faith in market efficiency, expressed in simple maxims such as 'you can't buck the market', and 'the market knows best'.

4.8 Faith in the conclusions of the strong version of the efficient market hypothesis appears to be unaffected by recent experience of persistent asset mispricing in markets such as those for dot.com stocks, securitised debt instruments and sovereign lending, and subsequent abrupt correction of these asset mispricings. The case for the general application of mark to market accounting relies to a substantial extent on the belief that market prices have the informational content implied by similarly strong versions of the efficient market hypothesis: that market prices are the best available estimate of the fundamental value of the relevant assets.

4.9 Efficient market theory, and its influence, are relevant both to the diagnosis and prescriptions of this Review. They are relevant to our diagnosis because, if the strong efficient market view were valid, the problem we have been asked to investigate would not exist. While market prices and fundamental values might diverge, nothing could be known or said about the nature of such divergence. If market prices did immediately incorporate all knowable information about long-term decisions and their consequences and prospects, company executives, asset managers and investors would share a common interest in arriving at decisions which would, on the basis of the best available information, maximise the value of the company in both the short and long-term.

4.10 This conclusion is derived from the assumptions of the model, not from evidence about the world. The principal value of the model is not in revealing the truth of its conclusions but in drawing attention to the ways in which the assumptions of the model do not hold, and hence the reasons why market prices are likely to diverge from fundamental value.

- Information about future company performance is speculative and imperfectly transmitted
- There is potential for misalignment of incentives along the investment chain
- Cognitive biases lead individuals and their agents to behave in ways different from the assumed concept of rationality[19].

4.11 The issue of information provision and dissemination is central. It has long been recognised that there is a logical contradiction embedded in the efficient market hypothesis[20]. If all relevant information were fully incorporated in market prices, there would be no incentive to obtain the information in the first place. The more efficient is the process described as 'price discovery' – the more rapid the incorporation of the views of market participants into market prices – the less the reward from engaging in the socially more

[19] See Camerer, Colin F. (1995), Individual Decision Making, in J. Kagel and A. E. Roth (eds) Handbook of Experimental Economics, Princeton UP.

[20] Grossman, Sanford J. and Joseph Stiglitz (1980), "On the Impossibility of Informationally Efficient Markets", American Economic Review 70 (3), pp. 393–408

important function of 'value discovery' – understanding the fundamental value of the company attributable to its potential earnings and cash flow.

4.12 Each intermediary has its own remuneration structure and business model. The incentives that emerge from their reward systems may not correspond with the interests of savers, or the promotion of the better performance of the companies in which funds are invested. The obligation to pursue these goals of higher returns and better performance might be imposed on intermediaries by regulation, but it is hard to imagine that such regulation will be perfectly effective if the relevant individuals or the businesses for which they work have different goals. The more extended is the chain of intermediaries, the more scope there is for such misalignment of incentives.

4.13 One important misalignment arises from the bias towards action which is found at almost every point in the equity investment chain. Corporate executives find that they can make a visible difference to the shape and perhaps performance of their companies by reorganisations, acquisitions and disposals; traders and market makers earn returns which are closely related to the volume of activity in the securities in which they deal; analysts are rewarded for the narratives they provide that generate buy or sell recommendations; investment bankers and advisers derive earnings from transactions; independent financial advisers have traditionally been rewarded by commissions and even after the Retail Distribution Review (RDR)[21] will recognise that their clients are more likely to be willing to pay for advice to do something than for advice to do nothing. Many people in the financial services industry who claim to be in the business of providing advice are in fact in the business of making sales.

4.14 Individuals and their agents may make cognitive errors that lead to decisions which do not correctly reflect their long-term financial interests. People may be unduly optimistic about their ability to pick outperforming stocks, identify talented asset managers, or obtain useful information about the capabilities of agents through 'beauty parades'. If the information we would like is not available, we may attach undue significance to the information we have. Anchoring is a tendency to deal with copious but imperfect information – noise – by seizing on, and perhaps building narratives around, data which appears salient but may have little relevance to the point at issue. Loss aversion is an inclination to attach more weight to losses than to equivalent gains. Because there are substantial elements of randomness in short-term price movements, even someone who makes money in speculative markets in the long run will lose money on many days. Optimism bias, anchoring and loss aversion have been widely documented in human behaviour generally, and in business and financial contexts specifically.

4.15 As we have observed, the influence of efficient market theory is large even among people who disclaim any interest in technical aspects of financial economics. Regulatory policy has been influenced by the view that the world is described by the efficient market hypothesis, and that if it is not then people are behaving 'irrationally' and should be induced to conform to the theory by education and the provision of appropriate information.

4.16 The belief that the best approach to information asymmetry is the provision of additional data may have led to a proliferation of data ill adapted to the needs of users, and to a belief that activities whose attractions are derived from the exploitation of information asymmetry are acceptable if accompanied by full, even if largely incomprehensible, disclosure.

[21] Retail Distribution Review, at: http://www.fsa.gov.uk/rdr.

4.17 Measures to increase the supply of data may increase the problem posed by cognitive biases such as excessive optimism, anchoring and loss aversion by increasing the amount and volume of noise generated by the financial system. We do not share the view that since these behaviours would not exist if people behaved as the model asserts they should, public policy should proceed as if these 'irrational' behaviours do not exist: such an approach would not be consistent with the fundamental goals of creating high performing companies and providing good returns to savers.

4.18 A better approach may be to design structures which reduce the opportunities for behaviours founded on cognitive errors on the part of savers and their agents – if indeed these behaviours are irrational: it is far from certain that in a world characterised by radical uncertainty, in which not only the probability but the nature of future outcomes is unknown, such behaviours are, in any real sense, irrational. The attempt to make the world conform to the model may also have done harm in other contexts. In particular, attempts to relieve principal-agent problems by creating complex incentive arrangements for corporate executives and for fund managers may have aggravated rather than relieved potential misalignment of interests.

4.19 This Review agrees with the assessment of Jean-Claude Trichet, Governor of the European Central Bank during the 2007-8 crisis, that the economic models used by his advisers 'seemed incapable of explaining what was happening in the economy in a convincing manner'[22]. We consider that economic analysis is helpful in understanding the issues we have been asked to examine, but we approach such analysis in an eclectic rather than ideological frame of mind.

[22] Reflections on the nature of monetary policy non-standard measures and finance theory, Speech by Jean-Claude Trichet, President of the ECB, Opening address at the ECB Central Banking Conference Frankfurt, 18 November 2010, at: http://www.ecb.int/press/key/date/2010/html/sp101118.en.html

5 The role of asset managers

5.1 Chapter 3 emphasised the increasingly central role of asset managers, both in modern equity markets generally and to the concerns of this Review in particular. There are many different types of asset management. Traditionally, asset managers were 'long only', buying positions in companies and holding them for extended periods. Hedge funds often adopt short positions, selling stock they do not own in the hope of profiting from price falls. Many traditional managers have adopted elements of hedge fund strategies. Passive managers replicate the performance of an index, while active managers attempt to add value.

5.2 For the purposes of this Review the most important distinction in the styles of asset managers is between those whose primary focus is on the activities of the company – its business, its strategy, and its likely future earnings and cash flow – and those whose primary focus is on the market for the shares of the company – the flow of buy and sell orders, momentum in the share price, and short-term correlations between the prices of different stocks.

5.3 The Investment Management Association (IMA) suggested to us that:

> '*a distinction should be drawn between those who mainly trade shares (for example, banks and other proprietary traders) and those, like asset managers, that invest. Proprietary and principal traders that buy or sell equities with their own capital, including hedge funds and those with high portfolio turnover such as 'high frequency traders', tend to be driven by short-term market trends and turn their portfolios over rapidly. They will not tend to analyse underlying performance. Those that invest also buy and sell equities but tend to hold them for the long-term based on their analysis of a company's prospects and underlying performance*'[23].

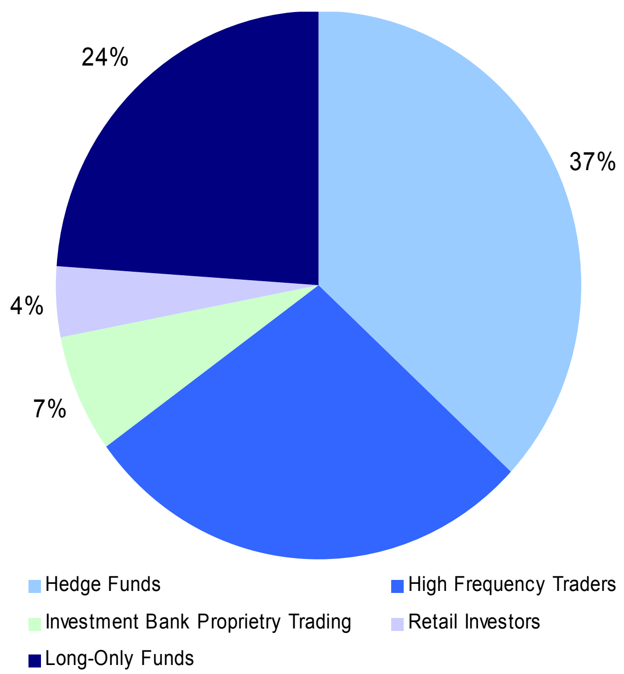
We think this identification of traders and investors is helpful and important.

5.4 However, this distinction between investors and traders is not clear cut. All investors manage the timing of their purchases and sales in the light of market conditions, and many arbitrage trading strategies – those which seek to profit from divergent movements in the price of related securities – are based explicitly or implicitly on characteristics of the company. Not all investors have long holding periods in mind: nor, necessarily, should they. An activist investor who seeks changes in strategy or management may anticipate that the effects of those actions on the share price will be felt in a short period and plan an early sale. But investors tend to hold shares for longer than traders, and the differences in the preoccupations and activities of investors and traders are nevertheless marked.

[23] The Kay Review of UK Equity Markets and Long-Term Decision Making, IMA Response, November 2011, at: http://www.investmentuk.org/assets/files/consultations/2011/20111123_KayReview.pdf

5.5 Traders account for most of equity market turnover, while most shares are held by investors. Figure 8 shows the breakdown of turnover by beneficial owner type. Hedge funds, high frequency traders and proprietary traders are responsible for 72% of market turnover (but a small proportion of shareholding).

Fig 8: Percentage of UK Average Daily Share Turnover, by Beneficial Owner Type



Source: TABB Group
Note: Population covered consists of all UK markets, including; LSE, Chi, Turquoise etc.

5.6 The existence of some trading activity assists the functions of markets. Trading provides investors with liquidity and may facilitate the dissemination of information among market participants. It is, however, a matter of simple arithmetic that any net profits from trading activity in aggregate are a cost to investors.

5.7 The converse – that the net value of trading activity overall is the benefit it offers to investors – is also true. Investors benefit from liquidity to the extent that they are confident they can dispose of holdings within a reasonable time scale at a price close to the value they attribute to these holdings, and therefore need hold less prudential cash in their portfolios. The volume of trading activity needed to serve this function is probably not large, and the value of that trading activity is necessarily related to the amount of capital which traders are able to deploy in support of it.

5.8 The rapid growth of high frequency trading concerned many investors among our respondents. They were sceptical about the claimed benefits of this activity in providing liquidity, and about whether these benefits would actually exist in the periods of acute market uncertainty when such liquidity might actually be required.

5.9 The government is already engaged in a review of high frequency trading[24], and we have not sought to duplicate it. That review will engage in wider issues, such as the systemic resilience of computerised

[24] Details can be found at:http://www.bis.gov.uk/foresight/our-work/projects/current-projects/computer-trading

trading. We would urge that the costs and benefits of such trading for long-term investors, and the effect on price volatility, should be the subject of further research. We do not, however, believe that the recent growth of high frequency trading is, in itself, a major contributor to short-term behaviour on the part of either savers or companies, although the phenomenon of high frequency trading has emerged as an aspect of a broader trend which favours trading over trust relationships.

5.10 Another function of trading is the transmission of information within the market, an activity often described as 'price discovery'. We have already stressed that from the perspective of long-term decision-making by savers and companies, what matters is value discovery, *i.e.* activity which yields insight into the fundamental value of a company's shares. Investors, in the words of the IMA, '*tend to hold (equities) for the long-term based on their analysis of a company's prospects and underlying performance.*' Only the process of analysis can acquaint investors with the long-term prospects of a company, and only as a result of analysis will companies receive relevant signals from the market about the direction of the business. Effective value discovery is necessary to the utility of either voice or exit as mechanism of performance enhancement.

5.11 We observed in Chapter 4 that some of those we interviewed attributed almost magical powers to 'the market', as if 'the wisdom of crowds' somehow generated knowledge of the competitive strengths of a company which was not vouchsafed to any individual participant in the market or member of the crowd. Anthropomorphisation of 'the market' in phrases such as 'markets think', or 'the view of the market' is common usage. It should hardly need saying that the market does not think, and that what is described as the view of 'the market' is simply some average of the views of market participants. 'The market' knows nothing except what market participants know, although it is of course possible that the average of a range of competing views may be a better estimate of fundamental value than the opinion of some (or conceivably all) individual market participants. The assessment of 'the market' is therefore only as good as the quality of the analysis done by asset managers and those who advise asset managers.

5.12 Analysis of the long-term capabilities of a company will be valuable to those who undertake it only if any insights such analysis provides are not in the price. Profits can be earned through good analysis only if there is a window of opportunity in which profits can be earned from better and deeper understanding. 'Imperfections' in markets, in the sense that information is not fully or immediately reflected in market prices, are the only things that can make securities analysis profitable to investors.

5.13 What the efficient market hypothesis would characterise as market imperfections are essential to its functioning. As a result, measures to make the market more 'efficient', in the technical sense implied by the efficient market hypothesis, may have the effect of making the market less efficient in the broader and more important sense of achieving better resource allocation through better corporate decisions. This is an important practical consequence of the insight described in Chapter 4; if the market were truly efficient, in the narrow sense, there would be no incentive to obtain the information needed for value discovery.

5.14 Equity markets enable savers, and their agents, to operate on time horizons different from those of the companies in which they invest: this is one of their central functions. Nevertheless, the time horizons on which asset managers are judged influence the dominant style of asset management.

5.15 Analysis will not be rewarding if its results are immediately incorporated in market prices, nor will it be rewarding if its results are never incorporated in market prices. Two time horizons are critical here: the time horizons over which the performance of asset managers is judged (the performance horizon) and the speed at which the prices of securities revert to their fundamental value (the value discovery horizon).

5.16 If the performance horizon on which the asset manager is judged is short relative to the value discovery horizon on which security prices revert to their fundamental value, then the asset manager will give more attention to the views of other market participants, and how they are formed and changed, than to the fundamental value of the company itself. Other asset managers will be under the same pressures to act in the same way. Funds will be redirected to managers with impressive short-term performance, and those who exhibit such performance will include a disproportionate representation of those who are skilled in interpreting and anticipating the activities of other asset managers.

5.17 Thus any shortening of the performance horizon over which companies are assessed, or any increase in the value discovery horizon which results from an increase in the complexity of corporate operations, risks a vicious circle of increasing attention to market trends and diminishing attention to fundamental value.

5.18 The consequences of the coexistence of a short performance horizon and a long value discovery horizon were memorably described by Keynes in his famous metaphor of the beauty contest: “It is not a case of choosing those which, to the best of one’s judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees”[25]. An objective measure of the beauty of the subject of the photograph becomes irrelevant: indeed the photograph need not be a representation of the subject at all. The greater the volume of trading activity relative to investment activity, the greater the premium attached to anticipation of the changing views of other traders relative to knowledge of the strengths and weaknesses of companies.

5.19 Our objective is therefore to increase the length of the performance horizon and reduce the value discovery horizon. Asset managers are mostly hired by other intermediaries – asset holders such as pension fund trustees and insurance companies, by other asset managers, or on the recommendation of investment consultants or independent financial advisers. The time horizons used for decisions to hire or review investment managers are generally significantly shorter than the time horizon over which the saver, or the corporate sponsor of a pension scheme, is looking to maximise a return.

5.20 Asset holders will normally receive monthly performance information from their asset managers and will typically discuss this performance on a quarterly basis. We heard conflicting reports on the frequency with which they engaged in substantive review.

5.21 A large body of evidence suggests that there is little or no serial correlation in asset manager performance. Past performance is not necessarily a guide to future performance: it is, in fact, virtually no guide to future performance. Savers, and asset holders, who make decisions to reallocate funds to asset managers who have recently outperformed their competitors are anchoring on noisy but copiously available quantitative information in the face of considerable uncertainty.

5.22 Frequent performance monitoring does, however, encourage the practice of closet indexation – actively managed portfolios which nevertheless mimic closely the composition of an index. Only by following a benchmark closely can a fund manager expect to avoid lengthy periods of underperformance if such performance is measured on a monthly or quarterly basis.

5.23 The decisions of asset holders to hire and review asset managers are typically based on their performance relative to index benchmarks, or their performance relative to other asset managers in a

[25] Keynes, John Maynard; The General Theory of Employment, Interest and Money *London: Macmillan, 1936*.

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

5.24 The words 'relative' and 'absolute' are used in two different senses. Relative performance may be defined as performance relative to a benchmark index: absolute performance is the total return generated by a fund or portfolio. Hedge funds generally describe their objective in terms of absolute returns, and the terms hedge fund and absolute return fund are sometimes treated as synonymous.

5.25 But relative performance may also refer to the performance of a fund relative to other funds pursuing similar asset classes or investment strategies. Thus it makes sense to talk about the relative performance of an absolute return fund, and indeed commercial hedge fund indices are published to facilitate such assessment.

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

5.27 Another large fund manager put it particularly clearly:

"For beneficiaries, the risk is that such a mandate will not deliver the returns that at least match the liability. For the investment manager, the risk is underperformance against the selected benchmark".

We were told that the result of all these pressures was frequent resort to 'closet indexation'. Although those who appointed asset managers were seeking – and paying for – active management, the portfolios that were constructed for them tended closely to follow the index.

5.28 Many of the issues which concerned respondents, and which are at the heart of the questions for this Review, are the product of this emphasis on relative performance. The interests of beneficiaries are largely interests in long-term absolute performance. The concern of asset managers – and the basis on which they are monitored by many asset holders, and by advisers to asset holders and retail investors – is short term relative performance. This misalignment of incentives creates many problems.

5.29 Returns to beneficial owners, taken as a whole, can be enhanced only by improving the performance of the corporate sector as a whole. Returns to any subset of beneficial owners can be enhanced, at the expense of other investors, by the superior relative performance of their own asset managers. Asset managers search for alpha, risk adjusted outperformance relative to a benchmark. But savers collectively will earn beta, the average return on the asset class[26].

5.30 Competition between asset managers to outperform each other by anticipating the changing whims of market sentiment – Keynes' beauty contest – can add nothing, in aggregate, to the value of companies (just as the contest Keynes describes does not make any of the faces portrayed more beautiful) – and hence nothing to the overall returns to savers. This competition is the search for alpha and, to a first approximation, the aggregate of alpha is zero. Any positive impact on company performance and overall returns to savers must come through investment research which aims to understand the activities of the company and their long-term consequences, and from direct engagement with the company itself.

5.31 Analysis of the fundamentals of a company has no direct impact on the underlying value of a company (just as observing which face is most beautiful has no direct impact on the attractiveness of the faces). But fundamental analysis has an indirect effect, which may be very large, in enabling companies to make long-term decisions with greater confidence that the benefits of such decisions will be recognised by investors. The part of the benefit accruing to those who undertake the research, however, will be linked to the transitory profit opportunity described earlier in the chapter.

5.32 Effective engagement will directly increase the value of a company: thus even if its effects were immediately reflected in share prices some returns would immediately accrue to those who undertake it. Nevertheless, those who undertake such intervention must devote resources to such engagement, while their share of the benefits would reflect only the proportion of the shares of the company which they own. Thus most of the benefits of engagement will be derived by other shareholders. In the current market environment both analysis and engagement have something of the character of public goods – most of the benefits accrue to people who do not undertake them.

5.33 Even if the benefits of analysis and engagement would be large, for both companies and beneficiaries, the incentives for any individual fund manager to pursue these benefits are weak, since although the individual fund manager bears all the costs most of the additional return will accrue to people who are not his clients and most of the business benefits will accrue to other firms.

5.34 The structure of the industry favours exit over voice, and gives minimal incentives to analysis and engagement. Many respondents clearly regarded engagement with companies as a cost. One of the largest UK asset managers, with both active and passive funds under management, told us that "engagement with investor companies requires investment of time and resource which can be seen as an encumbrance in a situation where mandates are being awarded based on fees". Many of these respondents nevertheless accepted that such engagement was a responsibility of the asset manager: some thought it should be paid for, as a distinct charge or a levy on all investors. A few respondents suggested that there was some evidence that activist fund managers could recover the costs of strong engagement through superior performance. This lack of incentive for engagement is an inescapable feature of an investment landscape characterised by a competitive fund management industry and the fragmented holding of shares. Many respondents commented that the increased dispersion of share holding had aggravated this problem.

5.35 As we observed, the behaviour of equity market participants is the product of the market structure in which they operate, the uncertainties they face, and the regulatory environment in which they operate.

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[26] In the capital asset pricing model, β is the correlation of the return of a security with the overall return on that class of securities. Since the β of the class of securities is one, the term β is frequently employed in the sense used in the text.

5.36 The existing structure of the investment chain is the product of a highly regulated environment, and an overriding principle of such regulation is that since agents cannot be trusted, layers of oversight are required. If asset managers cannot be relied on to do their job, then risk managers must review them and trustees supervise them: if trustees do not have the skills to do this, and mostly they do not, then they can call on investment consultants.

5.37 Even if the existing structure of the investment chain had emerged spontaneously – which it decidedly has not – there is little reason to think that the outcome of a competitive fund management industry would necessarily be best for savers. Asset management is a product for which it is very difficult – however much information the consumer may have – to assess product quality: who knows what the future performance of a particular manager will be? Yet small differences in quality may lead to large differences in outcome. In such a market, price competition is not an effective weapon; margins and charges will tend to be set at conventional levels and, if market entry is easy, products and producers will proliferate.

5.38 This pattern of misdirected competition, focussing on marketing and product proliferation but not price, seems to describe the UK fund management industry. At retail level, we see clustering of charges for actively managed funds with some upward drift (the effects of the RDR may have produced the first reversal of this trend but its effects, in particular on the total charges paid by the retail customer, have yet to be fully seen). In the wholesale market, we learnt that the normal practice of pension funds was to appoint a fund manager after a beauty parade (in which investment consultants advise on what is beautiful or more often, on what investment consultants generally think is beautiful) and subsequently to negotiate some reduction on the proposed charging level. The same clustering in charging structures although at much higher levels, is observed in hedge funds and in private equity.

5.39 Since 'Big Bang' removed obstacles to the consolidation of financial services businesses in 1986, regulation has not concerned itself with issues of market structure. Indeed the application of competition policy, the main policy tool for influencing market structure, has been restricted in financial services. The approach has been to let market structure emerge as a result of market forces. If the results are unsatisfactory, the policy response has been to develop detailed prescriptive rules governing the conduct of financial services firms. These rules have become steadily more extensive and more intrusive and, while an attempt was made to step back to 'principles based regulation', this has not in practice stemmed the growth and extent of regulatory oversight, a development which gathered pace after the crisis of 2008.

5.40 The Vickers Commission on Banking Regulation[27] gave primacy to issues of market structure: its principal recommendations were the ring fencing of deposit taking banks and the promotion of competition in the banking sector. We believe this structural focus is the right approach. If the market structure is such as to give the right incentive, then appropriate behaviour should follow, and regulatory oversight of such behaviour can be reduced: if market structure and incentives are not right, then regulation which imposes behaviour which conflicts with the commercial interests of participants is likely to enjoy limited success.

[27] Independent Commission on Banking, Final Report, September 2011, at: http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf

6 Establishing trust

Principles

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;

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.

Directions

It follows from these principles that:

Regulatory practice should favour investing over trading, not the other way round;

Agents at each stage of the equity investment chain should review their practices with a view to establishing more effective working relationships based on trust and respect

6.1 In the last five years, there has been a wide erosion of trust in financial intermediaries and in the financial system as a whole. This erosion is not a result of misplaced public perception, which can be addressed by a public relations campaign; it is based on observation of what has happened. That erosion of trust is the long-term consequence of the systematic and deliberate replacement of a culture based on relationships by one based on trading increasingly characterised by anonymity, and the behaviours which arise from that substitution. In the context of asset management, trust implies stewardship.

6.2 The concept of stewardship originates in the responsibilities of a steward as manager of a household or estate, and the historic analogy is apt. The essential characteristics of the steward are understanding and engagement – understanding the needs and expectations of those with whom the steward deals, and engagement with those who meet these needs and discharge the expectations of the principals. Trust and respect are key to the role of the honest steward. The honest steward expects to be rewarded for the discharge of that trust, but on a basis of full disclosure and only on that basis. Analysis and engagement are the characteristics which, in Chapter 5, we sought in asset managers, and we would equally look for in company directors and asset holders. The Review believes that stewardship should be key to the equity investment chain.

6.3 Our approach, which emphasises relationships based on trust and respect, rooted in analysis and engagement, develops and extends the existing concept of stewardship in equity investment. This extended concept of stewardship requires that the skills and knowledge of the asset manager be integrated with the supervisory role of those employed in corporate governance: it looks forward to an engagement which is most commonly positive and supportive, and not merely critical.

Recommendation 1: The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.

6.4 This Review adopts as a basic premise the belief that the investment chain will work best if those who invest funds in equity markets have trust and confidence in the agents with which they place the funds and if the companies which list on equity markets have respect for those who rely on their earnings and cash flow to generate returns on their savings and security in their retirement. If the relationship between companies and savers is mediated through a series of intermediaries, as it normally is, trust and respect between companies and savers can be achieved only if this mutuality of trust and respect is reproduced throughout the investment chain.

6.5 An ethos of trust and confidence is the principal mechanism by which information asymmetry and misalignment of incentives can be addressed, and by which savers and companies can achieve their long-term objectives. Anonymous relationships accompanied by high trading volumes cannot establish such an ethos.

6.6 The erosion of trust and respect is a feature not just of the equity investment chain, but of financial markets generally, and is perhaps a wider social phenomenon still. Regulation has attempted to compensate for the erosion of trust and respect by implementing rules of behaviour designed to enable people to deal with each other with greater confidence. Regulation has enjoyed a degree of success in achieving these objectives but the burden of compliance on market participants has increased steadily.

6.7 The further thrust of regulatory policy has been to deal with problems of erosion of trust, and of information asymmetry more generally, by imposing ever more demanding requirements of reporting and disclosure. We heard many complaints about the costs of fulfilling these obligations and about the information overload imposed on users as well as providers. Yet we were also confronted with many demands that still more information should be provided. When trust and respect are absent, then the search for more information to allow closer oversight is likely to be interminable.

6.8 At the same time, misalignment of incentives has been addressed by the introduction and development of bonus and incentive schemes of increasing complexity. Particularly though not exclusively, in the context of executive remuneration, this attempt to create identity of interests between agents and principals has in practice become a principal source of friction between them.

6.9 The search for trust and respect is not a matter of nostalgia for an earlier era. The market for corporate securities has been vulnerable to fraud and abuse from its inception: the South Sea Bubble set back the rise of the corporate economy for a century and a half, and it is eighty years since Lord Kylsant went to prison. Trust can be maintained successfully only if breach of trust carries serious legal and commercial consequences. To observe that not everyone can be trusted, and that there should be serious penalties for breach of trust, is however very different from building a system of financial services law and regulation around the proposition that most people cannot be trusted. There is a real danger that such a system will stimulate the very behaviour it seeks to constrain, as people come to believe that appropriate standards of behaviour are defined by rules rather than by the integrity of the participants.

6.10 The primary purpose of financial intermediation – in all financial markets, including equity markets – is to provide the assessment and oversight of the use of savers' funds which savers cannot undertake for themselves. It does not seem likely that this objective will be better achieved through trading between anonymous agents than through direct engagement by intermediaries with the users of funds,

6.11 The recommendations of this Review are based on the overarching principle that effective financial intermediation is based on the application of skill and judgment in the assessment of the capabilities and the circumstances of the companies that attract savers' funds, and the needs of the savers who provide these funds. These qualities of skill and judgment in appraising corporate capabilities and savers' needs cannot be provided effectively through transactions in markets populated by people with no specific knowledge of either providers or users. The 2007-8 financial crisis was the direct result of failure to recognise this essential truth about the nature of financial intermediation.

6.12 The fragmented structure of shareholding and the widely diversified structure of share portfolios has limited both the capacity and the incentive for asset managers to engage effectively with companies. There are two routes, not mutually inconsistent, of addressing that issue:

- To make shareholding less fragmented
- To encourage asset managers to act collectively

6.13 The chain of intermediation should be shortened. Outsourcing of functions based on the development of specialist skills and the use of technology to achieve economies of scale is to be welcomed. But in an environment in which trust and confidence are lacking, the process of hiring advisers to review the work of other advisers can multiply indefinitely, creating a self reinforcing cycle of mistrust and complexity. The addition of successive layers of oversight and accountability not only adds to cost but also dilutes trust and judgment, and creates additional possibilities of misalignment of incentives.

6.14 At each stage of intermediation, relationships should be fewer and deeper. Diversification of a portfolio can be achieved with a relatively small number of stocks if these stocks are substantially uncorrelated: conversely the diversification seemingly provided by a portfolio which contains a very large number of stocks is illusory if movements in the individual stocks are strongly correlated with each other. This principle applies not just to portfolio management, but to commercial relationships more generally. In the equity investment chain the development and maintenance of relationships based on trust, respect and the confident and open exchange of information is possible only to the extent that these objectives of fewer, deeper relationships and a short chain of intermediation are achieved.

6.15 The provision of information should as far as possible be tailored to the needs of users. There are obvious, and serious, limitations on the ability of any standard template – whether a corporate annual report or a monthly portfolio update – to fit the circumstances of the wide variety of organisations which provide the information and the wide variety of organisations or individuals who receive it.

6.16 We do not therefore favour the continued elaboration of such generalised information obligations: the demand for ever more disclosure is a process with no end, and users will never be satisfied, because in the absence of genuinely cooperative relationships no amount of data or formal documentation will give all users what they think they require. This does not, of course, exclude the possibility that some specific additional mandatory disclosures will be useful either as constraint on providers or because of its value to a wide class of user.

6.17 In tune with this general approach the Review believes that it is generally more effective, and in the long-term less intrusive, to give incentives to do the right thing than to attempt to prevent people who are subject to inappropriate incentives from doing the wrong thing. When regulation imposes requirements which are directly contrary to the business interests of those who are regulated, the likely result is formal rather than substantive compliance, and a regime which will be undermined by avoidance through regulatory arbitrage. Frustration and the resulting ineffectiveness of policy then leads to further complexity.

6.18 Regulation of market structure is generally preferable to regulation of market behaviour. This lesson has been learned and applied in the regulation of other industries, such as transport and utilities, but has not been sufficiently recognised in financial services. Regulation based on behavioural prescription tends to be at once extensive and intrusive, yet limited in effectiveness and vulnerable to problems of regulatory capture – a tendency to see issues through the eyes of the industry rather than its customers. All these outcomes are characteristic of the regulation of financial services and have developed in recent years.

6.19 Trust and respect cannot be established by regulation. Regulation can, however, establish a framework that encourages trust and punishes those whose behaviour constitutes abuse of trust: it is salutary, and disappointing, that the serious regulatory offence is described as market abuse rather than customer abuse. Government, and its agencies, can play a major role in creating a culture of trust and respect by making clear the type and standards of behaviour which are expected from those who manage the funds of UK savers or who direct investment towards UK companies, and by exerting formal and informal pressure on those who fall short of these standards. Those who fall short of norms of good practice – or even of ordinary decent behaviour – should not expect to be employed, or supported, or otherwise rewarded, by the UK taxpayer.

6.20 Nor should they be supported by other intermediaries. The most powerful mechanism for establishing a culture of trust and respect is for intermediaries and market participants to impose it on each other. Conversely, the contagious effect of failure to observe these standards at any point in the investment chain undermines them at every point in the market chain.

6.21 We therefore favour the development of clear and specific guidance as to good practice over the elaboration of detailed regulation. Such definition of good practice would set out principles rather than prescribe behaviour or business models, and would allow flexibility to individual circumstances and for change over time.

6.22 To that end we set out in following chapters Good Practice Statements for company directors, asset managers, and asset holders. Our intention is that these should be adopted and developed by these groups, and that the Government should encourage this to happen. We do not believe the principles set out in these statements should be translated into specific regulatory requirements. However, we do envisage that Regulators will also endorse these principles, consider to what extent existing regulatory requirements may prevent their adoption, and seek to align existing guidance and codes of practice with them. We believe that such statements of good practice would complement, and inform further development of the Corporate Governance Code and Stewardship Code, and the development of relevant industry-led standards, such as the International Corporate Governance Network's Model Mandate initiative[28] and the recent proposals of the Investors Working Party on Stewardship[29].

[28] International Corporate Governance Network, The ICGN Model Mandate initiative**:** Model Contract between Asset Owners and their Fund Managers (2012) at:
http://www.icgn.org/files/icgn_main/pdfs/agm_reports/2011/item_9.2_icgn_model_mandate_initiative.pdf

[29] The Investor Stewardship Working Party Report, 2020 Stewardship: Improving the Quality of Investor Stewardship, Tomorrow's Company at:
http://www.forceforgood.com/Uploaded_Content/tool/2132012172742724.pdf

Recommendation 2: Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should takes steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements.

6.23 Voluntary compliance with general good practice enables markets to operate in favour of intermediaries who choose to observe good practice. When regulation imposes complex and universal burdens, the market pressure for intermediaries to distinguish good from bad practice in those with whom they deal is muted or even suppressed.

6.24 Our very clear sense, after an extended series of meetings and consultations with those involved in the equity investment chain, is that the vast majority of people employed in it want to derive satisfaction from doing a good job: a good job in the sense in which we have defined it, which is developing a financial services system that promotes high performing companies and delivers good and secure returns to savers. Conscientious stewardship is, for most people, an inherently satisfying activity.

6.25 Most asset managers and asset holders adopt this approach. But we also encountered frustration amongst these communities. Both regulation and the market environment were seen as getting in the way. Many of those to whom we talked saw regulation as an extensive bureaucratic structure which imposed costs and did little to protect the interests of market users: they saw the emphasis on transactions and trading as a means of enriching market intermediaries rather than advancing the interests of market users. Yet the direction of travel seemed to them only to be making things worse. There was a near universal expectation that the burden of regulation would increase, with no expectation of corresponding benefit – and that the conclusions of this Review would tend to increase that burden. These respondents felt that the traders were now in charge and that the transaction oriented culture was entrenched.

6.26 The majority of company directors with whom we spoke, and many of those involved in advising companies, also shared the perspective of stewardship. But not all did: some adopted a view that reflected the financialisation of companies we described in Chapter 1, viewed the company as a portfolio of businesses, and stressed the movement of the share price as a measure of corporate performance. As in the financial services industry itself, there is a tension between the values of stewardship and a transaction based culture.

6.27 The Review believes that we can contribute most effectively to good long-term decision making in British business and finance by promoting a culture of stewardship throughout the equity investment chain. The most important links of the chain, for these purposes, are the relationship between directors and their companies, the relationship between asset managers and the companies in which they invest, and the relationship between asset holders and asset managers. We favour establishing statements of good practice in each of these relationships, to be provided for company directors, asset holders and asset managers, describing the responsibilities of stewardship.

6.28 The objective in each case is to set out the principles relevant to good long-term decision making: to focus the attention of directors on the success of the company in the long-term: to lengthen the time scale of measurement of investment performance by influencing the priorities of asset holders and asset managers: to shorten the time horizon of value discovery by placing greater emphasis on the relationship between the asset manager and the company. In subsequent chapters, we discuss the specific content of these good practice statements in more detail.

6.29 Good practice statements would not be binding in legal or regulatory terms, but we believe most participants in the investment chain would be likely to comply with them, and it is likely that regulatory authorities and the Courts would have regard to them.

7 Strengthening the investment chain

Principle

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

Directions

It follows from these principles that:

Asset managers should have greater incentives to engagement. Active asset managers should typically have more concentrated portfolios which are more differentiated from each other and from benchmark indices, and regulatory discouragements to such behaviour should be reduced or removed;

There should be more opportunity for collective action by asset managers who should have greater freedom to act collectively without fear of regulatory consequences;

Passive managers should recognise a special responsibility to improve the performance of the index they track.

7.1 The UK asset management industry is fragmented and portfolios typically contain many stocks. The business models of asset managers depend on their relative performance. Asset managers compete to outperform each other, but such outperformance is gained largely at the expense of each other. These factors blunt incentives for constructive engagement with the companies in which funds are invested. This problem can, and should, be addressed in two ways:

- Expanding the opportunities for collective action by asset managers
- Encouraging a market structure in which asset managers' portfolios earn returns by enhancing the performance of the underlying investments

7.2 We believe the need for collective action should be addressed by the establishment of an investors' forum, the objectives of which are to facilitate both supportive and critical action on issues of concern to investors, in general and in relation to particular companies. We anticipate a body with its own distinctive voice, independent of government and companies, which can strongly advocate the position of savers to those companies in which they have an economic interest, always recognising that it is the performance of these companies that generates the rewards savers seek.

7.3 The body should be formally independent of any existing body and have its own secretariat. The Government would not be represented on the body or fund it, although Government should engage in dialogue with it, should explicitly encourage the establishment of such a body and would have a primary role in facilitating its formation. Such Government involvement would make clear to asset managers, including asset managers which are not UK based, that the UK Government not only permits but welcomes collective action of this kind. Such a signal would also encourage sovereign wealth funds to participate.

7.4 Rather than a formal, static body, we anticipate that the membership and format of the forum would be sufficiently flexible to accommodate both general discussion of issues of company strategy and corporate governance, and also specific issues arising at particular companies.

7.5 We anticipate that asset managers, as the dominant players in equity markets, would be critical participants in the forum. Some asset holders, and especially the largest pension funds, already engage in the kind of stewardship activity we seek to encourage. The forum should therefore be sufficiently flexible in its composition to build on this activity – accommodating in particular asset holders who retain some or all of their investment and stewardship functions in-house. We also anticipate that some board positions might be taken by individuals with experience in senior executive positions in large quoted companies.

7.6 We noted in our interim report (at paragraph 5.24) that fund managers were concerned by legal or regulatory restrictions on collective action, and particularly by the concert party rules of the Takeover Panel. We also observed that some scepticism had been expressed about the basis of these latter concerns. The Panel presented a convincing argument for the need to interpret those rules on a case by case basis, but expressed itself willing to work with the forum in developing a mechanism by which the forum could seek clearance for its proposed collective actions.

7.7 We regard it as highly unlikely that action within the forum we envisage could trigger a mandatory bid under the Takeover Code, since, as explained by the Panel in its Practice Statement No. 26[30], this would require not just that the 'activist investors' operating within the forum sought to replace the board of the company in question, but that they intended to do so by installing connected directors.

Recommendation 3: An investors' forum should be established to facilitate collective engagement by investors in UK companies

7.8 We believe that the contribution of asset managers to meeting the needs of both savers and companies can be enhanced by careful analysis and development of what is meant by good practice in asset management. Many asset managers might answer simply that good practice in asset management is making money for clients.

7.9 This response is of course correct; and in particular correct in its emphasis that the responsibility of the asset manager is to the savers who provide the funds for investment. The response leads immediately to the further observation that good practice in asset management – and by asset holders – will focus on absolute long-term, and not relative short-term, returns.

7.10 The observation that good practice in asset management is making money for savers needs to be supplemented by the answer to further questions: When? And how? Over what period is the money made for clients? What differentiates one asset manager's attempts to make money for clients from another's?

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[30] See http://www.thetakeoverpanel.org.uk/statements/practice-statements

7.11 Business strategies can make money in the short-run, but fail to do so in the long-term– several examples of this short-termism were illustrated in Chapter 1. Investment strategies can also make money in the short run but not the long-term. The reasons arise from risk and uncertainty and the self-referential nature of the behaviour of market participants.

7.12 Picking pockets whenever the opportunity arises, or tailgating on motorways, are strategies which most frequently prove rewarding in the short-term but are unrewarding in the long-term, and the jails and cemeteries of the world are filled with people who engaged in this form of short-termism. Conversely, locking the front door when leaving the house is a costly strategy most of the time but usually profitable in the long run (although it is rarely possible to know whether it has in fact been profitable).

7.13 All these problems arise from asymmetric probability distributions, in which frequent gains (or losses) are punctuated by infrequent but much larger losses (or gains). Such structures are frequently found in nature, and actively sought in financial markets, where consistency of performance is favoured and the distribution of rewards also asymmetric (winners receive a fraction of profits, while the share of losses is generally limited to receiving zero).

7.14 We described in Chapter 5 how investing strategies are less attractive, relative to trading strategies, if performance is judged on shorter time horizons. The asset manager who (correctly) believes he has a better understanding of the fundamental value of a company must expect to incur regular underperformance until the unpredictable time at which the mispricing is corrected.

7.15 The issue was clearly illustrated in the new economy bubble and in the credit crunch of 2007-8 (and in most financial crises). Investors who (with hindsight correctly) stayed out of overpriced tech stocks or risky securitised instruments made losses, or smaller profits, than other competitors for years until the correction occurred.

7.16 Excessive frequency of reporting of investment performance is consequently not simply damaging to the broad policy goal of better stewardship, but likely to be damaging to the long-term interests of savers and beneficiaries regardless of any stewardship benefits. The theme that insistence on the provision of information on a short-term basis is not simply burdensome, but may be actively damaging, will be taken up further in Chapter 10.

7.17 Few asset managers state that their aim is simply to make money for clients, nor do their clients give them such an unconstrained brief: they profess different specialisms and styles, and when they fail to make money for their clients, as they frequently do, they tend to blame the specialism and the style rather than themselves.

7.18 Good practice for asset managers is to make money for clients by following a particular – pre-announced – asset management style in which the manager professes strength – and selection of the style that is likely to make money should be a decision on which the asset manager is judged. In the long run, a good manager of bad assets is a bad manager.

7.19 Good practice by asset holders who place funds with more than one manager is therefore to achieve diversification of asset management styles. This is not the same as the practice of asset allocation to standard benchmark categories. As has recently been widely observed, the globalisation of product and capital markets means that the correlations between these benchmark categories are now often high.

7.20 We were made aware of the particular problems which smaller companies face in equity markets. The rapid growth of trading activity has been principally focussed on large companies, and liquidity in smaller stocks has tended to decline. The general unattractiveness of the IPO market is a problem which is almost entirely faced by smaller companies. We have observed that quoted companies today are mostly cash generative, but it is smaller companies which are generally more likely to need equity finance

7.21 We believe the general direction of our recommendation to asset holders and asset managers should, overall, be helpful to smaller companies: more concentrated portfolios, less requirement for liquidity, less emphasis on short term relative performance, and closer relationships between asset managers and investee companies. These are key elements in our good practice statements for asset managers.

Good Practice Statement for Asset Managers

Asset Managers should…

1. recognise that they are in a position of trust managing client money and should act at all times in the best long-term interests of their clients, informing them of possible conflicts of interest and avoiding these wherever possible.
2. operate within a culture of open dialogue with their clients – building an agreed understanding of investment objectives and risks, which is informed by their investment expertise.
3. provide information to clients, including information on investment performance, in a way which is clear, timely, useable and relevant to the long-term creation of value in the investee companies, and therefore to clients' investment objectives.
4. disclose fully all costs that fall on investors in a way that investors can understand.
5. ensure that income generated from lending securities is rebated in full to the fund, with any related costs disclosed separately.
6. adhere to the investment strategy agreed with clients.
7. prioritise medium to long-term value creation and absolute returns rather than short-term returns from market movements when making investment decisions.
8. build an ongoing relationship of stewardship with the companies in which they invest to help improve long-term performance – recognising that engagement goes beyond merely voting.
9. make investment decisions based on judgments about long-term company performance, informed by an understanding of company strategy and a range of information relevant to the specific company, and avoiding reliance on single measures of performance.
10. be prepared to act collectively to improve the performance of their investee companies.
11. be paid in line with the interests and timescales of their clients. Specifically remuneration should not be related to short-term performance of the investment fund or the performance of the asset management firm. Instead, a long-term performance incentive should be provided in the form of an interest in the fund (directly or via the firm) to be held until the manager is no longer responsible for that fund.

7.22 Good practice in asset management therefore involves pursuing with some conviction an asset management style that reflects the manager's own particular capabilities, knowledge and experience. Good practice in asset management involves substantial 'active share', since indexation to a benchmark is a commodity that can be purchased extremely cheaply. Good practice in asset management therefore leads naturally to stewardship activity.

7.23 The proportion of savers' funds which can be actively managed effectively is limited. Passive investment will therefore capture a substantial part of the total. Indeed if account is taken not just of the funds which are explicitly passively managed, but of the passive share of what are described as active funds but which are 'closet indexed', passive management already accounts for a very large share of UK equity investment.

7.24 Passive funds managed with reference to UK equity indices must hold companies which are included in those indices. One of the criteria for inclusion in the UK indices is that issuers should have a premium listing. The listing regime, operated and overseen by the UKLA, is independent of the UK indices, and the ability to gain indexation is from the regulatory perspective a consequence, not the primary objective, of obtaining a premium listing. These indices include an increasing share of companies based in jurisdictions whose legal systems may not be as robust as those of the UK, and whose local corporate governance standards may be considerably lower than those required of UK premium listed issuers. By inclusion in UK indices, such companies effectively force investment from savers whose funds are invested through passive vehicles. Asset holders and other respondents expressed concern about this forced investment. We suspect that many savers would not want to hold stakes in some of the companies which have recently achieved listings.

7.25 With the globalisation of UK based companies, and the listing in London of many businesses with no UK activities, the universe of companies listed in London has little in common beyond the fact of the listing. We are aware that there have been discussions over the composition of the main UK indices, but the FTSE Group told us that it does not plan either revisions to its indices or to publish alternative indices in response to these concerns. We have some sympathy with the view that a proliferation of indices would be undesirable and recognise that if there were clear demands from customers for a specific alternative index there would be a commercial interest in providing one.

7.26 The objectives of 'passive investment' strategies may not be best achieved (other than tautologically) by replicating a benchmark index based on all stocks in a particular category, if that category is not defined by any criteria of relevance to the underlying beneficiaries. An indexed portfolio holds a wide range of stocks – the widest possible in any asset class – but holding a wide range of stocks is not the same as holding a diversified portfolio. An index fund is concentrated in a few sectors – in the UK index financials were once heavily represented, now oil and mining are. Telecommunications and pharmaceuticals are over-represented relative to their contribution to economic activity, because these activities are mostly conducted by large companies. House-building is mostly conducted by small businesses; automobile construction is not included in the UK index because it is mostly conducted by foreign companies. 'Fundamental indices' whose weights are related to the economic significance of companies or markets rather than based on market capitalisation are an attempt to devise passive strategies which avoid these defects, and also to escape the losses from long-run mean reversion which arise from the adoption of market weightings in index funds or benchmarks. Index funds are necessarily overweight in overpriced sectors and underweight in underpriced sectors and this is true even if one has no knowledge of which sectors are over or underpriced.

7.27 Should passive strategies be based on indices at all? Interest in passive strategies developed in the 1970s as a result of scepticism about the ability of asset managers to pick stocks successfully and concern about the level of fees and costs of turnover associated with many active management strategies. One large endowment described to us the development of a portfolio of large, global companies with the intention of building stakes in these companies and holding them indefinitely. Such a strategy may have lower trading costs than even a conventionally passively managed fund. We note that several asset managers are now developing similar investment strategies.

7.28 We might end our discussion of good practice in asset management with a description of the method followed by Warren Buffett, the most successful of all asset managers:

- Selection of a comparatively small portfolio of businesses, based primarily on the characteristics of the company rather than the cheapness of the stock
- Very long holding periods
- Stakes in the company of sufficient size to be capable of a (rarely exercised) influence on management succession and strategy

7.29 Two other features of Buffett's approach deserve attention in any formulation of good practice in asset management:

- There is near complete alignment of the interests of savers and fund manager, since Buffett is rewarded almost entirely by the increasing value of his own holding in the fund
- Because the fund is a listed closed ended security, where savers hold shares in the fund company rather than units in the fund, there is liquidity for savers even although there is little or no liquidity in many of the holdings within the fund. The closed-ended investment company model also means that fund managers can take a long-term view: they are not obliged to buy or sell shares in companies they hold in unfavourable market conditions in response to savers buying or selling the fund.

7.30 We believe that Buffett's success and strategy should represent a good starting point for any discussion of good practice in asset management.

7.31 Asset holders have a duty to their savers, which they should manage to fiduciary standards. They will meet these obligations best by establishing relationships with fund managers in whom they have trust and confidence, and reviewing these relationships at intervals of no less than three to five years, emphasising absolute returns (and emphasising absolute returns whether the asset manager's mandate is general or specialist). If they meet and monitor the asset manager more frequently – and they should – it should be with a view to developing the relationship and a better understanding of the manager's investment process, not to review short term performance relative to other managers with a similar mandate. Asset holders should recognise that diversification is most likely to be achieved by a diversity of asset management styles, rather than by calculations derived from an asset allocation model, the employment of a large number of managers, or the selection of a large number of stocks.

Good Practice Statement for Asset Holders

Asset Holders should…

1. recognise that they are in a position of trust managing client money and should act at all times in the best long-term interests of their clients, informing them of possible conflicts of interest and avoiding these wherever possible.
2. operate within a culture of open dialogue with beneficiaries – building an agreed understanding of investment objectives and risks.
3. provide information to beneficiaries, including information on investment performance, in a way which is clear, timely, useable and relevant to clients' investment objectives.
4. be proactive in setting mandates for asset managers based on open dialogue about agreed investment objectives.
5. set mandates which focus managers on achieving absolute returns in line with beneficiaries long-term investment objectives, rather than short-term relative performance benchmarks.
6. recognise that diversification is the result of diversity of investment styles.
7. review performance no more frequently than is necessary, and with reference to long-term absolute performance.
8. encourage and empower asset managers to engage with investee companies as a means of improving company performance to deliver investment returns.

7.32 Even if our recommendations are fully adopted, we anticipate that public equity markets will continue to decline in importance relative to other means of financing companies or mobilising savings. A corollary is the rise of other vehicles for matching savers and companies – direct investment by asset managers or through private equity and the issuance of bonds, either directly or on public markets. The blockage in the channels of intermediation through the banking system has stimulated interest in disintermediated methods of finance which are also facilitated by developments in information technology. The principal asset managers are active in all these growing areas of the financial system. Direct contact between asset managers and companies, without the intermediation of public markets, may be a significant – and welcome – step in the evolution of UK equity markets.

8 The business environment

Principles

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'

Directions

It follows from these principles that:

British business should emphasise the creation and maintenance of competitive advantage in operating businesses, which is the only long-term source of shareholder value. Investors should support this objective.

8.1 As described above, both the Companies Act 2006 and our proposed Good Practice Statement for Company Directors emphasize the obligation of directors to promote the success of the company and that such success is to be measured over the long-term.

8.2 Some respondents suggested to us that the statutory responsibilities of a director should be revised to put more stress on long-term factors, including a wider engagement with shareholders. We do not agree that such a restatement is necessary to encourage long-term decision making, regardless of whether a restatement might, or might not, be desirable on other grounds. The present definition leaves no doubt that the appropriate time horizon is a long-term one. If some directors think that their duty can be reduced to an obligation to achieve the highest possible share price in the short-term, then the problem arises because they misunderstand British law, not because the law is itself in need of revision.

8.3 The obligation of directors to promote the success of the company in the long-run corresponds to the concept of stewardship as are described in Chapter 6: the director is steward of the assets and activities of the company. The obligations of the director are to the company and relate to the assets and activities of the company. The obligations of the asset manager or asset holder are to the saver whose money is invested in his funds and subsequently in the shares of the company. There is a clear difference. The company director is not a meta-fund manager, handling a portfolio of investments on behalf of a saver.

8.4 Many of the submissions we received concerned the effect on companies of mergers and acquisitions. Some of the companies described in Chapter 1 – such as ICI and GEC – were severely damaged by meta-fund management. Senior executives embarked on a programme to reorganise the business portfolio within a company, with damaging results on both the operating businesses and the companies. Other companies – such as RBS – were victims of hubristic acquisition programmes. The bias towards

Good Practice Statement for Company Directors

Company Directors should…

1. understand their duties as directors under the Companies Act 2006, and in particular acknowledge the relevance of considering long-term factors, including relevant environmental, social and governance issues, and the reputation of the company for high standards of business conduct, in fulfilling their duty to promote the success of the company.
2. acknowledge that long-term value creation in the interests of shareholders is best served by strategies which focus on investing appropriately to deliver sustainable performance rather than treating the business as a portfolio of financial interests.
3. act to ensure that the intermediation costs associated with a publicly traded company are kept to a minimum.
4. ensure that corporate reporting is focused on forward looking strategy.
5. facilitate engagement with shareholders, and in particular institutional shareholders such as asset managers and asset holders, based on open and ongoing dialogue about their long-term concerns and investment objectives.
6. provide information, in the context of corporate reporting and ongoing shareholder engagement, which supports shareholders' understanding of company strategy and likely long-term creation of value, including by agreeing a range of performance metrics relevant to the company.
7. communicate information to shareholders which aids understanding of the future prospects of the company, even if this means going beyond (but not against) the strict requirements of accounting standards, for example on market valuations.
8. not allow expectations of market reaction to particular short-term performance metrics to significantly influence company strategy.
9. refrain from publishing or highlighting inappropriate metrics which may give a misleading impression of anticipated future company performance.
10. be paid in a way which incentivises sustainable long-term business performance: long-term performance incentives should be provided in the form of company shares to be held until after the executive has retired from the business.

action, exemplified here by managers and their advisers, is evident. But a substantial body of academic evidence suggests that little or no value is added to business by merger activity.

8.5 We were reminded that Britain has the most open market for acquisitions of any large country. We do not subscribe to the view that the 'market for corporate control' can be relied on to ensure that the management of corporations is always placed in the most capable hands. There are too many instances of failed transactions, some of which were described in Chapter 1.

8.6 There are bad owners, and there are bad acquisitions. The purchase of ABN Amro by RBS was a spectacular instance, and RBS was unfortunate in successfully snatching the poisoned chalice from another UK based company, Barclays. In Chapter 1 we described several other instances of failed acquisition strategies by UK companies.

8.7 Nor do we think that the UK can be wholly indifferent to the location of corporate headquarters. Despite the globalisation of business, most companies retain an identifiable national identity. That identity influences corporate policy, and with the head office goes a contribution to the local community. In 1982, competing bids for Royal Bank of Scotland were blocked following an adverse report by the Monopolies and Mergers Commission (as it then was) which emphasised the impact on Scotland of a loss of corporate headquarters. The later takeover in 1986 by Guinness of Distillers was allowed, guidelines having in the meantime been revised to focus on competition issues exclusively. The different impact of the two decisions on the local economy is evident today.

8.8 In tax policy, the UK is not indifferent to headquarters location. Adjustments have been made to the tax code and tax rates with reference to precisely this issue, even though the likely impact of relocation on operations was likely to be small.

8.9 We consider that the belief that the equity markets will always reach the right answer when bids are made owes more to ideology, or concern for the interests and bias to action of London based financial advisers than to an evidence based assessment of effects of merger and acquisition activity on UK business. But it is not easy for companies and their advisers to anticipate the long-term consequences of large corporate transactions – there would be fewer failed transactions if it were.

8.10 We believe that the limitation of public regulation of merger activity to those transactions which raise concerns of competition policy (with some limited exceptions) has not necessarily been beneficial. But to reverse that change would be to restore a general public interest test in place of a competition test. This raises difficult questions.

8.11 The problems with a general public interest test go beyond mergers and other corporate transactions which are privately beneficial but damaging to the public interest, the problem with which regulatory agencies are commonly asked to deal. The problem is that there are many transactions which are not even privately beneficial. But we are reluctant to put either Ministers or the Competition Commission in the position of being expected to overrule bad business judgment, especially when that judgment has been affirmed by Boards and shareholders.

8.12 A general hostility to foreign ownership would be completely unjustified. Some foreign acquisitions of UK based companies have improved performance and many high performing UK businesses are foreign owned. Some respondents complained that foreign companies are often allowed to make acquisitions here in circumstances where a UK company would not be allowed to undertake a similar transaction in the acquirer's home market. But this is little more than a debating point. RATP and EDF are not bad providers of transport and electricity in the UK by virtue of the fact that UK businesses would find it difficult to operate similarly in France. The UK government might seek to negotiate an opportunity for UK companies to buy French state owned businesses on the basis of a supposed principle of reciprocity, but such negotiation would not be likely to be successful; the probable outcome is that Britain would lose the skills and experience of French operators, not that Routemaster buses would be found on the streets of Paris. While a comparison is often made between protectionism in trade in goods and services and protectionism in attitudes to foreign takeovers, there is more that is misleading in the analogy than is helpful. This failure of analogy is true more generally of the comparison between markets for goods and services and the 'market for corporate control'.

8.13 There is, however, substance in a more subtle version of this reciprocity argument. The openness of the UK acquisition market means that UK companies are a favoured target of global investment banks which seek to promote transactions activity. The greater difficulty of accessing other markets may mean that

UK companies are disproportionately vulnerable to unwanted attention from predators. Such attention may be disruptive and destabilising even if no bid in fact materialises.

8.14 But this is equally true if the potential predator is a UK based company. The central issue for the purposes of this Review is not whether there are too many takeovers of UK companies by foreign companies, but whether there are too many takeovers of and by UK companies generally. We have described, with regret, the financialisation of UK business, the rise of the would-be meta-fund manager, and the tendency for some chief executives to be preoccupied with deal-making rather than developing competitive advantages in operating businesses.

8.15 We believe a sufficiently proportionate response is that the British Government should adopt a more sceptical attitude to claims of the benefits from large corporate transactions. We wish there were fewer such transactions, but we do not think it necessary – or at this stage desirable – that the Secretary of State should have extended authority to block merger proposals.

8.16 There is considerable variation between jurisdictions in the legal powers a government has to block unwanted takeovers. There is also considerable variation between jurisdictions in the ability of private actors to block takeovers to which they are opposed. In continental Europe, there are many legal differences and more concentrated shareholding is common. In the United States, law and market practice have been more favourable to 'poison pills' and other means of resistance by incumbent management to unwanted bids. Britain is distinguished from these jurisdictions by the combination of low public and private barriers to takeover and the laissez-faire attitude which successive governments have adopted since the 1980s.

8.17 The existing formal and informal authority of government and its agencies to discourage bids is considerable. The relevant regulators could arguably have prevented the BAA or ABN Amro transactions. Many large foreign companies would think twice before pursuing a major UK acquisition in the face of clearly expressed hostility from the UK Government.

8.18 We take the view that the Government should use its informal and formal authority as effectively as possible. It should take a more active approach towards companies planning major acquisitions of UK businesses, or UK businesses planning major acquisitions outside the UK. It should take a negative view of a transaction only in cases where at least one of the following conditions was fulfilled; the acquirer appeared to have significantly less capacity to manage the business than the existing management team; the combined concern appeared likely to be substantially weaker financially than the existing UK business; a probable consequence of the transaction was a material loss of high level functions, or of employment from the UK. Assurances given to allay these concerns should be regarded as binding on the company, by legal means if necessary.

8.19 The power to make references to the Competition Commission would of course continue. Such references would, as now, be based principally on the significance of the deal in relation to the relevant market, not on the overall actual or potential economic significance of the transaction for the UK economy.

8.20 We consider that this change of approach would bring British practice more in line with that of other countries while retaining a relatively liberal stance, balancing legitimate public policy concerns against support for the exercise of honest business judgment. If companies and their advisers were resistant to such informal guidance, or if assurances about behaviour were regularly flouted, it would be appropriate to consider fresh legislation.

8.21 But the key issues are not those of legislative authority but the culture of the corporation and the financial sector. It is in that evolving culture that short term decision making has emerged and it is in that evolving culture that remedies for it are to be found. The primary mechanisms for the evaluation of acquisition and divestment proposals are, and should be, discussion in the board of the companies concerned, and consultation, formal and informal, with shareholders. These mechanisms are relevant for both the acquired company and the acquirer.

8.22 Respondents expressed concern about directors' duties when their company is the subject of a bid. What can, or should, directors do if they consider the prospective acquirer will not be a good owner of the company? There are two issues:

- Can the directors legally recommend that a high bid be rejected?
- Does it matter anyway, since the bid is likely to be accepted by shareholders?

8.23 The first issue would seem to be clearly met by reiterating the obligation of the directors to have regard to the long-term success of the company for the benefit of its members. The second issue raises wider matters of public policy. In a number of controversial contested bids, the outcome has been settled by arbitrageurs, who have appeared on the share register only with the objective of gambling on the bid going through. The suggestion was made to us that such arbitrageurs should be deprived of votes. But the presence of arbitrageurs is not the central issue: these agents can only vote shares that others have recently sold to them. If there is a problem, it is that the underlying holders of shares are unwilling to reject an immediate offer at a premium to the previous share price even if they believe that the still higher fundamental value of the share will be revealed in the long-run. Or that they have no idea of the fundamental value of the share, but take the money and run. The development of stewardship activity by asset managers is the best – and probably the only – effective check on such actions.

8.24 In a number of recent cases – such as the abandoned plan for G4S to acquire ISS – stewardship activity by asset managers has blocked excessively ambitious acquisition activity by UK based companies. We welcome the increased readiness of these managers to act in this way. It was suggested to us that the materiality threshold at which shareholder approval of large transactions is required might be lowered. But most substantial deals already require shareholder approval, and many of the worst transactions in the past were enthusiastically supported by shareholders. We doubt whether a reduction in the threshold would have much practical effect.

8.25 An alternative suggestion is that the level of acceptances required from shareholders in the target firm should be raised. The Takeover Panel recently consulted on this issue and found that a large majority of respondents were opposed. Perhaps more importantly, such a move would have relevance principally for hostile transactions, which account for a very small proportion of all bids.

8.26 Another check would be provided by more effective non-executive directors. The best restraint on a chief executive with excessive self-confidence – a frequent cause of the problems that concern us – is a powerful board: but over-ambitious chief executives may be less likely to favour challenging boards, and even strong boards may be slow to act. As they were in some of the cases we have discussed. We observe the paradox of RBS, where the company's striking success with one acquisition – that of National Westminster Bank – encouraged further acquisitions which proved calamitous. Sir David Walker's report[31] gave particular emphasis to the failure of corporate governance in this area.

[31] A review of corporate governance in UK banks and other financial industry entities Final recommendations, available at http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf

8.27 The best and most effective mechanism for controlling mergers – both discouraging British companies from making bad acquisitions and blocking undesirable takeovers of British companies – would be for managers to review evidence on merger performance and some of the salutary experiences of individual companies described above. But optimism bias is evident: even though a large proportion of acquisitions fail, managers believe their acquisition will succeed. In the absence, or insufficient presence, of scepticism from boards then the most effective mechanism of restraint is through the development of stewardship activities of the kind we have described. The present situation is a product of the trading culture in which both companies and their shareholders operate, and the best route to reform is to change that culture.

8.28 With some reservations, therefore, we incline against recommending immediate changes in the current regulatory framework of merger control in the UK. We hope that the other changes we recommend will have a cooling effect on corporate transactions, and that boards and asset managers will as a result provide a more powerful safeguard against excess of ambition or hyperactivity.

Recommendation 4: The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves.

8.29 The evidence we received suggested considerable disenchantment by companies with public equity markets. Companies find the regulatory burden demanding: some viewed corporate governance initiatives as sterile exercises in box-ticking and were particularly critical of the role of proxy voting agencies. They complained about the costs associated with issuance. This disenchantment is reflected in their behaviour. Some companies have gone private: many companies are unwilling to list: alternative means of obtaining finance, such as private equity and debt, have become more popular. As we observed in Chapter 2, equity markets have ceased to be a significant source of funds for investment in UK business.

8.30 We do not believe there are any arguments of policy for promoting the use of public equity markets as an objective in itself. What is important is that businesses should have access to equity funding when it is commercially appropriate: that sufficient liquidity exist to enable investors to have opportunities to exit an investment without damaging the company in which they have invested: and that there should be mechanisms to hold company boards and managers to account for their stewardship. Public equity markets are a means of achieving these objectives, but they are not the only means of achieving these objectives.

8.31 The AIM market has proved a mechanism which serves these purposes without imposing the costs and complete range of obligations associated with a full listing. The growth of private equity, and the development of a market in secondary participations has, in effect, created another equity market. We welcome the growth of alternative markets of this kind and would be happy to see wider opportunities for savers to access other forms of equity investment alongside traditional public markets. Such evolution requires the parallel evolution of asset managers who accept greater illiquidity and broader responsibilities to their ultimate investors as part of their stewardship activities.

8.32 Several respondents suggested that long-term investors should receive explicit advantages over traders. Capital gains tax concessions were suggested, but since most shareholders, whether investors or traders, do not pay capital gains tax this seems of little relevance. Others favoured differential voting rights. One suggestion was that voting rights should accrue only after being on the share register for a 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

9 Fiduciary duty

Principle

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

Directions

It follows from these principles that:

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

9.1 The equity investment chain will best serve the interests of savers and companies if relationships along it are based on the concept of stewardship. Stewardship entails mutual confidence based on trust in the agent with whom money has been placed, and respect by that agent for the saver whose money has been placed. The promotion of stewardship requires that the responsibilities of agents should be defined in ways that establish and reinforce trust and respect. Stewardship is incompatible with conflict of interest. Trust in an investment chain will be as strong as the trust in the weakest link of that investment chain.

9.2 Many respondents raised the question of the fiduciary character of relationships in the equity investment chain. There was evidently considerable uncertainty and difference of view among respondents as to whether a fiduciary duty exists in these relationships, and if it does exist as to its precise content.

9.3 The concept of fiduciary duty is a creation of common law. Case law[33] identifies a fiduciary as 'someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence'. The Law Commission has characterised a fiduciary relationship as one in which there is 'discretion, power to act, and vulnerability'. Vulnerability typically arises when the agent receiving the funds has (or should have) greater knowledge or expertise than the person or agent placing the funds. Vulnerability is therefore closely associated with information asymmetry.

[33] Bristol & West Building Society v Mothew [1998] Ch 1 at 18 per Lord Millett.

9.4 Pension fund trustees have common law fiduciary obligations by virtue of the trust deed which governs the scheme. Company directors have specific statutory fiduciary obligations defined by the Companies Act. The legal position of other intermediaries is less clear. However the definitions above suggest that, as a matter of law, fiduciary relationships may well be found at every point in the equity investment chain where there is either advice or power to act.

9.5 Many asset managers we met were clear that their relationship with their client had a fiduciary character. Other intermediaries, however, were not: and some, including some asset managers, took the view that their relationship with clients was defined by, and limited to, the contract between them. Some client contracts appear to be written with such limitation in mind.

9.6 The core fiduciary duties are those of loyalty and prudence. Common law defines several facets of the duty of loyalty: 'A fiduciary must act in good faith; he must not profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his benefit or the benefit of a third party without the informed consent of his principal'. Fiduciary duty does not prevent agents in fiduciary relationships from being paid for their services on a commercial basis. It does prohibit the fiduciary from making a profit from the discharge of his duties except through a reasonable payment for services provided, and with the informed consent of the principal.

9.7 The legal duty of prudence has been set out for over a century: the obligation 'to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide'.

9.8 The Review does not believe that there could be any sound basis for placing trust in an intermediary who does not recognise these duties of loyalty and prudence, and considers that a relationship that falls short of these standards fails to show appropriate respect for an investing client. Whatever the current legal position governing particular relationships in the equity investment chain, effective stewardship is possible only if trust, confidence and respect are established and the steward proceeds on the basis of obligations of loyalty and prudence. Stewardship implies the management of funds to fiduciary standards. Good practice statements for asset managers or for asset holders should incorporate these fiduciary standards.

9.9 We consider that these observations remain true even, or perhaps especially, when savers use intermediaries to undertake investment on their behalf; in other words, the fiduciary obligation is not relieved by the identification of the immediate client as a professional or wholesale investor. The economic interest in all monies in the investment chain lies with savers, and it to the interests of these savers that the legal and regulatory responsibilities of equity investment intermediaries must be directed.

9.10 While defined benefits pension schemes normally have trustees, defined contribution schemes are normally governed by contract rather than by a trust deed. We do not believe that the fiduciary character of the management of pensions should be affected by this change. The economic interest in all monies in the investment chain still lies with savers.

9.11 Caveat emptor is not a concept compatible with an equity investment chain based on trust and stewardship. The fundamental philosophy of this Review is that equity investment will serve the long-term interests of promoting economic growth in the UK, and the interests of beneficiaries taken as a whole. This can be achieved only if the dominant purpose is the location of the most rewarding source of long-term return, rather than the selection of the intermediaries who are most likely successfully to outwit other intermediaries. As we have noted, the degree of trust, confidence and respect in an investment chain is the degree of trust, confidence and respect applicable to the weakest link in that investment chain.

9.12 Current regulatory obligations differ from the standards implied by fiduciary duty. The fiduciary duty is one of loyalty to a customer: the corresponding regulatory obligation in FSA Principle 6[34] is that 'a firm must pay due regard to the interests of customers and treat them fairly'. The regulatory obligation of disclosure specifies that 'a firm must pay due regard to the information needs of its clients, and communicate to them in a way which is clear, fair and not misleading'.

9.13 The regulatory principle governing conflict of interest is that 'a firm must manage conflicts of interest fairly'. That latter obligation is elaborated as requiring the firm to identify conflicts, and to disclose them, on request or if the firm believes itself unable to manage them effectively. These duties fall materially below the standards necessary to establish the trust, confidence and respect characteristic of stewardship.

9.14 We note that the FSA's principles are supported and delivered by detailed rules and guidance which prescribe how asset managers, advisers and others should conduct their business, and that these detailed requirements are substantially influenced by EU legislation. We therefore believe that it will be necessary for regulatory authorities at both EU and national level to review the extent to which existing regulation promotes relationships of trust and confidence and to orchestrate a shift to fiduciary standards.

Recommendation 7: Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.

9.15 Regulation imposes obligations on asset managers to disclose their charges to retail customers. Such disclosure is worse than useless if it is not comprehensive. Performance fees are a cost to investors. So are costs of portfolio turnover which are charged to the fund. It is anomalous that the costs of exercising voice are part of the management fee which must be disclosed to savers, while the costs associated with implementing exit are not. Moreover, investors who are effective stewards of their holdings are by that fact alone likely to have lower portfolio turnover than those who are not. The existing structure of obligations on disclosure of charges makes investment strategies appear more costly relative to trading strategies, and this impression is misleading. We hope that the current IMA consultation[35] will arrive at an appropriate disclosure regime. If it does not, the issue of full and meaningful disclosure should be advanced through regulation.

Recommendation 8: Asset managers should make full disclosure of all costs, including actual or estimated transactions costs, and performance fees charged to the fund.

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[34] FSA Handbook Statement of Principle 6, available at: http://fsahandbook.info/FSA/html/handbook/APER/4/6.

[35] Fund Management Charges, Investment Costs and Performance, Investment Management Association, 2012, at: http://www.investmentfunds.org.uk/assets/files/research/20120504-imastatisticsseriespaper3.pdf.

9.16 It was suggested to us that the FSA's focus on prudence has primarily related, not to the management of the funds of savers, but to the financial resources of the asset manager. In Chapter 5 we emphasised the fundamental tension between the business interests of asset managers – based essentially on short-term relative performance – and the common interests of savers and companies in long-term absolute returns. Fiduciary duty, which places an obligation on the agent to focus on the long-term welfare of the client, appropriately directs activity and advice towards investment in the underlying earnings and cash flow of the businesses in which the funds of savers are invested, and requires fiduciaries to educate their clients to accept periods of relative underperformance.

9.17 Fiduciary duty is, as previously discussed, derived from the core legal obligation 'to behave as a prudent man would in the conduct of his own affairs'. As a matter of law the 'prudent man' must exercise his own judgment – he cannot discharge his duty simply by doing what others do. Nevertheless behaviour which is broadly aligned with that of others in a similar position is less likely to be deemed imprudent. It was suggested to us that this standard leads to herding, or even 'lemming' behaviour, and that the wide use by pension fund trustees and other asset holders of liability driven asset allocation models based on modern portfolio theory has in part followed from this interpretation of the fiduciary obligation on pension fund trustees.

9.18 We believe there is force in this observation, and that imitation has helped to reinforce short-term behaviour in the pursuit of what is believed to be good practice. But 'herding' provides an opportunity to spread good practice as well as bad, and we hope that our Good Practice Statements will be effective in this way

9.19 The prudent man principle as applied to investment does not simply mean making the investments which the prudent man would make on his own behalf. The fiduciary invests on behalf of beneficiaries whose risk tolerance may differ from his own, and whose time horizons may not only differ from his own, but will frequently be longer than his own.

9.20 A number of submissions – in particular, powerful argument from Fair Pensions[36] – suggested that some pension fund trustees equated their fiduciary responsibilities with a narrow interpretation of the interests of their beneficiaries which focused on maximising financial returns over a short timescale and prevented the consideration of longer term factors which might impact on company performance, including questions of sustainability or environmental and social impact. They suggested that there was some legal underpinning for the narrow interpretation, citing the cases of Cowan v. Scargill[37] and Buttle v Saunders, that suggested that trustees might be under 'a duty to gazump'. Lawyers who participated in our discussions, however, suggested that the law allowed a more robust interpretation. Several commented that pension fund trustees who insisted on a narrow view of fiduciary duty were often hiding behind risk-averse legal advice, designed to protect the adviser and client rather than to provide guidance as to the proper discharge of fiduciary duty.

9.21 We encountered wide agreement as to what the appropriate behaviour of trustees ought to be, even if there was no such agreement on what the current legal standard of fiduciary duty is. Asset holders and asset managers ought to match their advice to the risk preferences and time horizons of ultimate beneficiaries: subject to that requirement they should adopt investment policies which maximise absolute long-term investment returns: they should invest in line with generally prevailing ethical

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[36] The Kay Review of UK Equity Markets and Long-Term Decision Making, FairPensions Response, November 2011, at: http://www.fairpensions.org.uk/sites/default/files/uploaded_files/KayEvidence_Nov2011.pdf

[37] Cowan v. Scargill [1985] CH 270 and Buttle v. Saunders [1950] 2 All ER 193

standards and take account of any specific wishes of their beneficiaries: but they should not use their position to advance political goals or other objectives not directly related to the welfare of their beneficiaries. Their duties are to all their beneficiaries but not to savers at large if they are not beneficiaries of the particular trust to which the trustee has obligations. This approach would not require, or even permit, asset holders or asset managers to depart from generally prevailing standards of decent behaviour even if such behaviour would be in the narrow financial interest of the beneficiary.

9.22 There was also wide agreement that the practice outlined above was followed by most trustees, although not necessarily by others in the equity investment chain. We consider that trustees should be reassured that what they do is in accordance with good practice and the law, and that similar standards should apply to other participants in the investment chain. While we believe that the common law provides clarity on what is meant by core fiduciary duties of loyalty and prudence, we believe that there is a need to clarify how these duties should be applied in the context of investment, given the widespread concerns about how these standards are interpreted.

Recommendation 9: The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers.

9.23 Short selling is, at first sight, incompatible with the concept of stewardship we advocate. Short selling implies a lack of trust and confidence in, and respect for, the management of the company whose shares are sold. We were reminded, however, that many of the most publicised cases of short selling have been instances in which managers had proved poor or even corrupt stewards of corporate assets and that the activities of short sellers had sometimes been a means of value discovery in the face of attempts by management to mislead investors.

9.24 Short selling could reach volumes in which the activity is self-reinforcing and damaging to the interests of sound companies. While this eventuality, which could profoundly damage long-term decision making, is certainly a possibility, we received little evidence that such a position had yet been reached.

9.25 Some respondents took the view that investors who are long in a particular stock, and who acknowledge stewardship responsibilities, should not encourage short selling by making their stock available for stock lending. For the reasons described above, however, we do not agree with this view. We are nevertheless concerned that the income from stock lending may not be separately disclosed, and may be retained in whole or part by the asset manager, although the receipt of this income may be reflected in whole or in part in lower explicit management charges. The risks associated with stock lending – essentially the risk that the stock is not returned and the collateral proves insufficient – remain with the fund whose stock is lent (and hence with the saver). There is therefore a divergence between the recipient of the income and the bearer of the risk for which the income is compensation. Such a divergence may distort competition and give an artificial, and inappropriate, incentive to engage in stock lending. More broadly, such divergence is inconsistent with fiduciary principles.

Recommendation 10: All income from stock lending should be disclosed and rebated to investors.

10 The information users need

Principles

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.

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.

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.

Directions

It follows from the above principles that:

- **Relevance to investors should be the principal criterion in determining reporting obligations**
- **Asset managers should increasingly negotiate, individually and collectively, the provision of the information they need to make good long-term decisions**
- **Noise in information– the frequent reporting of data irrelevant to long-term value creation – should be reduced**
- **Regulators, information providers and all involved in the equity investment chain should recognise that no single metric or model can provide a sure guide to long-term value in companies or equity portfolios**
- **The use of measures which are not related to long-term value creation should be discouraged by regulators and users**
- **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**

10.1 The demand for more information has been an instinctive response to a wide range of problems that have emerged in the financial services sector in recent decades. Disclosure and transparency have become mantras in policy and in regulation. And it is hard to argue. What do the reputable have to fear from disclosure? Who can be opposed to transparency?

10.2 The outcome is a cascade of information, or at least data. The constantly changing figures that clutter the screens of traders is supplemented by continuous display of events of supposed relevance to market values: annual returns and regulatory filings have steadily increased in length. The development of the internet means that most of this material can be accessible to everyone everywhere at any time. The nervous tapping of smartphones in the airport lounge symbolises the perceived need for constant connection to this flow.

10.3 But the opportunities created by modern information technology have led many people to overestimate the value of this flow of data. 'Data is not information, information is not knowledge, knowledge is not understanding, understanding is not wisdom'.[38]

10.4 Many of our respondents were critical of the burden imposed on both providers and users by these regulatory demands for data. Much of the data which flashes across screens is simply noise, although commentators constantly endeavour to attach significance to it. Much of the content of reports and filings is boiler plate – verbiage which is reproduced in almost identical form from year to year and by company after company. Some of the material in these reports is fluff – self congratulation with little substantive content.

10.5 Aside from the cost of collection and dissemination, useless information is often worse than useless. People may feel obliged to act on it, or fear that other people will oblige them to act on it, or believe that others will act on it. In securities markets, irrelevant information becomes relevant if you believe that others may think it is relevant, and such beliefs do not have to be well founded to be self-justifying.

10.6 Useful information may itself be buried by the sheer volume of data. It is claimed that the details of Enron's frauds were contained in regulatory filings, but these filings were so voluminous that few people had sufficient opportunity, incentive or ability to analyse what was happening[39].

10.7 And yet when we sought to shift complaint about the reporting burden to specifics, we encountered unease about the notion that we might dispense with any particular requirement. Recording or reporting has rarely been mandated without some valid purpose in mind, and people would recall that purpose. We received many submissions deploring the overall information overload but few proposing the deletion of any particular requirements: and at the same time, we also received many submissions demanding that new mandatory reporting requirements should be imposed. There was also a competitive element: those who deplored the burden of regulation on them often demanded that comparable regulatory obligations should be imposed on other market participants. The outcome is that the burden of regulation and reporting increases steadily, often without obvious purpose or benefit.

10.8 The mantra of transparency and disclosure is bound up with the view of efficient markets described earlier. The assumption has been made that information asymmetry can be overcome if markets collectively are supplied with sufficient, consistent, comparable and – in principle – equally available information. Traders can then make decisions on the basis of their own interpretation of this standardised data. Such thinking led to the conviction, or at least conventional belief, that the likelihood of mortgage defaults would be better judged by analysts in rating agencies equipped with

[38] Quote attributed to Clifford Stoll and Gary Schubert in Mark R. Keeler, 'Nothing To Hide' (2000), p.112

[39] Although, in fact, the critical information may not have been difficult to identify. The following article would suggest that problems could be spotted in first few pages: http://accounting.smartpros.com/x32702.xml

historic statistical series on mortgage defaults and house prices, than by experienced managers meeting prospective borrowers face to face.

10.9 Problems of information asymmetry are not unique to financial services: they are endemic in a complex modern economy. They are handled, in most cases, by the development of relationships of trust and confidence. Patients readily take advice from their doctors, not because of the disclosures the doctor makes when presenting a diagnosis, but because they believe their doctor has genuine concern to represent their interests. A driver sits contentedly in the driving seat of a car, not because he or she knows what is under the bonnet, but because the reputation of the manufacturer gives assurance that the car will be fit for purpose.

10.10 Because the reputation of both doctors and car manufacturers is generally high, rogue doctors and unreliable cars suffer the contagious effects of ill reputation. But where the general standards of products or service in a market are not high, effecting improvement is not easy: it is hard to sell a reliable car at a premium in a market in which general expectations are low. And when Japanese car manufacturers offered a step change in the reliability of cars, it took many years and considerable investment for them to establish a market position, although the end result was an increase in the reliability of all cars. The information provided to patients and drivers is the information they and their doctors and suppliers agree they need: if there is real trust in the relationship, this need not be very much.

10.11 Selectivity in information is essential, but on what basis? A newspaper is easy to read because the incentives of journalists are to stimulate people to read their copy. The financial interests of the newspaper are in establishing a cadre of loyal readers – and hence to provide news and information which is relevant to their interests. An annual report is not easy to read because its format is driven by regulatory requirements and those who write it often have little inclination or incentive to communicate information beyond that required to fulfil that obligation. The writers of annual reports mostly do not seek to attract readers to the next edition. Some annual reports are a commendable exception.

10.12 There has been considerable progress in recent years in the development of international accounting standards. We question, however, whether this trend may have emphasised comparability at the expense of relevance. Comparability benefits large international accounting firms, who aggregate data derived from the global operations of their clients, and comparability is necessary for traders who have little or no relationship with the companies in which they invest. The search for comparability is the product of an environment which emphasises the role of anonymous markets, in which investment decisions can be made without specific knowledge of the companies in which funds are invested

10.13 The search for relevance does not stop at the provision of comparable data, and may not start there. Relevance for purposes of stewardship advances from data to information to knowledge to understanding – and (perhaps) ultimately to wisdom in investment decisions. Knowledge and understanding are critical elements in development of trust relationships. The search for understanding acknowledges that the nature of the information which is helpful in understanding the activities of a company will vary from business to business and time to time.

10.14 Useful information is provided when the content of the information is driven by the needs of users, and when the providers of information benefit from establishing a continuing relationship with their users. The definition of information relevant to recognising a company's long-term capabilities is specific not just to the sector in which the company operates, but to the individual company and its particular strategy. That definition can only be determined as the result of negotiation between companies and asset managers. The ability easily to engage in such discussion is a primary strength of the model of internal allocation of capital within large firms with diversified activities, of private equity, and increasingly of debt finance. The increasing difficulty of engaging in such discussion is one reason for the relative decline of equity markets.

10.15 Asset managers described to us their view that such negotiation over information requirements is seriously restricted by insider rules: rules that prohibit trading by those who hold information which is not publicly available; and make trading by those in possession of such information a criminal offence if the information is price sensitive. People who are purporting to act in an executive or advisory capacity while in fact extracting information to trade on their own account, or to enable others to do so, are fraudsters in gross breach of fiduciary duty, and their accomplices are associates in a criminal conspiracy. Asset managers developing effective relationships with investing companies on behalf of their clients fall into another category altogether.

10.16 Insider trading has been illegal in Britain since 1980. The FSA gained criminal prosecution powers in 2001, although the first successful prosecution was not secured until 2009[40]. Enforcement proceedings in the US have also become more frequent, notably with the recent prosecutions connected with the disgraced hedge fund manager Raj Rajaratnam, But there has been little enforcement activity in other EU member states against fraudulent officers and advisers and the few prosecutions have mostly been directed against corporate executives rather than financial professionals.

10.17 Insider trading of price sensitive information in breach of fiduciary duty is a serious crime and perpetrators should suffer severe penalties. Effective regulation of insider trading has an important role to play in ensuring confidence in the markets. There is, however, a potential inconsistency of policy in advocating more effective engagement between companies and investors, and at the same time prohibiting investors from deriving financial advantage from such engagement beyond the limited extent that such engagement benefits all holders of stock. Considering the strong emphasis on market conduct, an increasing emphasis on shareholder dialogue and the move to a new regulatory regime under the FCA, it would be logical for a dialogue to be opened between the new regulator and investors about ensuring that these two policy objectives – shareholder engagement and market abuse adherence – remain aligned. This may increase market confidence and lead to better outcomes. .

10.18 Much of the information that is provided in standard templates is simply noise. For companies with long-term investment horizons, such as oil and mining companies, or utilities, or pharmaceutical companies, profitability can be meaningfully assessed only over a period of many years. Construction companies can be judged only over a complete economic cycle, and the recent financial crisis demonstrated – if demonstration had been needed – that the same is true of banks. Companies which are not required to make major long-term investments in physical assets may have brands and reputations whose value can be enhanced, or diminished, over many years. Businesses in industries with fast moving technologies depend on a continued capacity to generate a constant stream of successful new products.

10.19 For all these types of business, interim assessments of evolving performance are necessary, but can only be qualitative and subjective. The meaningful measurement of annual profit requires fine and subjective judgment, and quarterly earnings will be dominated by random fluctuations – or worse, will be managed to avoid them. The unreliability of short term estimates does not imply that useful

[40] http://www.fsa.gov.uk/library/communication/pr/2009/042.shtml

information cannot be given to asset managers who are in regular contact with companies and to shareholders generally, but such assessments will in large part be discursive rather than statistical and the appropriate form and frequency will be company specific.

Recommendation 11: Mandatory IMS (quarterly reporting) obligations should be removed.

10.20 We noted in Chapter 9 that institutional investors acting in the best interest of their clients should consider the environmental and social impact of companies' activities and associated risks among a range of factors which might impact on the performance of a company, or the wider interests of savers, in the long-term. And we have also referred to the obligation on company directors to have regard to such matters, among others, in the context of their duty to promote the success of the company. Some have argued that such considerations will only be possible if companies are subject to mandatory requirements to disclose information on their company's environmental and social impacts. We are inclined however to believe that for such considerations to be meaningful they should primarily be based on information which is material to investors, that this is likely to vary across different sectors and from company to company, and that it should therefore be disclosed in negotiations between asset managers and companies.

10.21 Non financial ("Narrative") reporting has an important role to play in transparency. 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 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.

Recommendation 12: High quality, succinct narrative reporting should be strongly encouraged.

10.22 Several respondents to the Review discussed issues around 'mark to market' accounting. The problems of mark to market accounting are evident when, as in most businesses, the assets critical to the value of the company are idiosyncratic: but it may also be true when there is a market in the relevant assets. The fundamental value of a tranche of a securitised product based on mortgages with a potential life of twenty years can be ascertained only over many years: short-term changes in the price of such securities were often the result, not of better information about the underlying assets, but the consequence of changing opinions of the price at which packages of mortgages (whose fundamental value was very difficult to ascertain) could be sold to other purchasers.

10.23 If the market prices of assets represent partly or wholly the beliefs of market participants about what other market participants do or will believe and if these market participants have little or no knowledge of the capacity of these assets to generate earnings or cash flow, then 'marking to market' conveys little or no information relevant to long-term decision making by companies or by asset managers, and gives little indication of the long-term value generated for savers. We do not believe that the process of marking to market, or otherwise implementing accounting standards, either does or should relieve those preparing financial statements from providing decision useful information.

10.24 Nor do we believe that it is necessarily true that the ability to price an investment fund on a daily basis necessarily gives either useful information to savers, or an assurance of fairness as between different savers. These things are likely to be true only if daily changing market prices are reflective of genuine changes in the fundamental value of the underlying assets. If fluctuations in reported prices are mostly the result of noise rather than shifts in fundamental value, frequent re-pricing creates inequity rather than fairness among beneficiaries.

10.25 This latter issue takes on greater importance with the growth of defined contribution pension schemes, in which individuals will invest and disinvest at dates and times over which they have no control. It is obviously necessary to establish values at which such transactions can take place. But if that is interpreted as an obligation to ascertain daily values, the obligation discourages investment in underlying assets that are not constantly re-priced. We doubt if a requirement for frequent re-pricing is in the long-run interests of savers.

10.26 We do not believe there are easy solutions to the problems posed for both mark to market accounting and fund valuation by noisy markets which are characterised by price volatility generated by changes in market sentiment and expectations which have little connection to changes in fundamental value. But the priority given to regular price information focuses attention on market fluctuations at the expense of fundamental value and creates biases in the investment decisions of both companies and savers. It is therefore important for users of accounts to be aware of these limitations.

10.27 Other flawed metrics give rise to similar biases. Total shareholder return over short to medium periods is typically dominated by changes in market assessments of fundamental value rather than changes in fundamental value itself. Ratios such as earnings per share and return on equity can be influenced by reducing the denominator rather than by increasing the numerator, so that these metrics can show positive returns even if the underlying value of the business is only maintained or even reduced.

10.28 Corporate executives judged by reference to such metrics have benefited from the opportunities these flawed measures of performance create, reducing the number of outstanding shares through buybacks, or by increasing the return on equity through increasing leverage or taking corporate assets off balance sheet. Measures of growth in earnings will be misleading if no allowance is made for capital reinvested in the business. As a result, financial actions may represent short-term decisions which add nothing to the enterprise value of the company even in the short-term and are likely to diminish its value in the long run.

10.29 Many widely used models raise similar issues of relevance. Risk models commonly employed in asset management firms measure risk by trading error relative to an index benchmark. Asset allocation models and insurance company solvency models commonly measure risk by reference to one year volatility, a measure which reflects the amount of market noise generated by trading activity rather than the underlying riskiness of the asset. Risk models used in the regulation of the investment process should focus on risk as perceived by savers, not risk as experienced by market participants. These risks are the failure of their investments to meet their reasonable long-term expectations over the time horizon for which they wish to invest.

10.30 Many metrics and models, like some of those described above, are simply flawed measures which should not be employed. Other metrics and models are useful when deployed in conjunction with a range of other measures. No single metric or model can provide an adequate picture of the long-term performance of a company or asset manager. This point is central to any discussion of mandates and remuneration structures.

Recommendation 13: The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations.

Recommendation 14: Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment.

11 Establishing the right incentives

Principle

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.

Directions

It follows from these principles that:

- **Any bonuses paid in the equity investment chain should be closely related to the agent's performance in determining long-term value, and the ability to realise the value of the bonus should be related to the realisation of that long-term value**
- **Rewards should reflect long-term value creation rather than the amount or volume of transactions**

11.1 Since the Review was established, executive remuneration has attracted more controversy and public attention than any other issue related to equity markets. The issue has been the subject of extensive review and consultation by the Department of Business, Innovation and Skills, resulting in Government reforms aimed at giving shareholders greater clarity on directors' remuneration and greater power to address disproportionate pay[41]. We do not intend to cover the same ground, but we are required to consider how the structure of executive remuneration may contribute to, or detract from, good long-term decision making.

11.2 Bonuses and similar rewards for senior executives in UK companies were relatively unusual until the 1980s, when share option schemes became increasingly common. This was an aspect of the general process we have described as the financialisation of corporate Britain. Share options were perceived as a means of aligning the interests of managers and shareholders.

11.3 We might ask why it is necessary or appropriate to pay bonuses to the directors of large companies at all. Many people doing responsible and demanding jobs – cabinet ministers, judges, surgeons, research scientists – do not receive bonuses, and would be insulted by the suggestion that the prospect of bonuses would encourage them to perform their duties more conscientiously. There are many criticisms of these professions, but rarely that they are not making the maximum effort. In all of these activities, successful performance is inherently rewarding, and the prospect of such a reward provides effective alignment of private and public interest.

[41] BIS consultation on enhanced shareholder voting rights regarding executive pay, at: http://www.bis.gov.uk/Consultations/executive-pay-shareholder-voting-rights?cat=closedawaitingresponse.

11.4 Senior executive posts in large companies may be different in this respect from other demanding and responsible positions, but it is not obvious why they are different. We have not heard any suggestion that senior executives tried less hard to promote the long-run success of their companies before bonus and incentive schemes proliferated, although it is difficult to see what evidence might be adduced to advance or dispute that thesis.

11.5 This is not to dispute that people frequently do specific things they are incentivised to do. Bonuses for politicians related to the growth of GDP, or for surgeons based on the survival rate of patients, or for actors based on the number of curtain calls, would affect behaviour. But not generally in desirable ways: the result would be to focus attention on short-term metrics which would frequently conflict with the long-term goals we would expect those engaged in complex tasks to pursue. Encouragement of short term behaviour is inherent in any pay structure in which performance bonuses constitute a substantial fraction of total remuneration.

11.6 A further possible effect of such pay structures would be to attract different kinds of people to these occupations, and people with motivations not necessarily better suited to the performance of the task at hand. Of course, successful judges, scientists, sports people do typically earn more than less capable ones, as a result of promotion to more demanding positions or of competition to obtain their services. But this is the indirect result of a market process of competition for their services which increases their base pay, not the consequence of a decision by a remuneration committee or a complex formula devised by a remuneration consultant.

11.7 However remuneration committees, executive incentive schemes and bonuses are today an integral part of our corporate culture, and therefore we should ask more specifically whether their current structure provides incentives to make good long-term decisions.

11.8 The first stages in the evolution of managerial bonuses focussed on share options. The deficiencies of share options as incentive were recognised in various reports[42]. The returns from options were asymmetric – managers shared gains, but not losses, with shareholders. Executives benefitted from general rises in the stock market and from general changes in market sentiment towards the sector in which the company operated, developments not related in any way to the performance of the business or individuals concerned. Share price movements over the short-term are the result of changes in expectations of the performance of a company rather than the actual performance of a company: over the long run, short term expectations and long-term outcome may be very different.

11.9 As a result of these criticisms, 'long-term' incentive plans were widely implemented. Typically these employed a variety of financial metrics – either absolute or relative – and made awards over a period of up to three years. At the same time professional remuneration consultants, who specialised in the design of incentive schemes, acquired increasing influence over remuneration. Remuneration consultants provide information about the practice of other companies, and their business growth depends on being hired by other companies. Their interests of remuneration consultants are more closely aligned with the interests of the members of the boards who select them than the interests of shareholders.

[42] See for example: Lewis, Matt (ED) Directors' Remuneration, Report of a Study Group chaired by Sir Richard Greenbury (17 July 1995) ECGI at:
http://www.ecgi.org/codes/documents/greenbury.pdf and Montagnon, Peter; Association of British Insurers, Revised Guidelines on Executive Remuneration (15 December 2005) ABI 136/5
http://www.abi.org.uk/Media/Releases/2005/12/ABI_UPDATES_GUIDELINES_ON_EXECUTIVE_REMUNERATION.aspx

11.10 The modal tenure of a corporate chief executive is in the range 3–5 years. Many, probably, most, important decisions about the performance and activities of a large, complex business will have consequences extending well beyond that period. And the incentive scheme is generally asymmetric in nature: it rewards good performance but the punishment for poor performance is, at worst, (compensated) loss of office. An incentive scheme which pays out during the term of office of the executive is thus biased against long-term decision making in two ways:

- Faced with particular strategic choices, there is an incentive to make decisions whose immediate effects are positive even if the long run impact is not – the type of issue identified at BP or Marks & Spencer
- Managers will be anxious to make strategic choices whose consequences are likely to be apparent within a short time scale – the issue at GEC.

11.11 There are paradoxical consequences. 'Long-term' incentive plans with a time span of three years may actively encourage short-term decision making. Incentives related to short-term share price movements, may in fact be more supportive of long-term decision making because share prices are generally more forward looking than historic accounting data. (though such incentives will create many distortions of their own, particularly those related to the management of expectations)

11.12 Therefore, to be consistent with a long approach to decision making:

- Any bonuses should be paid in shares
- The required holding period of those shares should extend significantly beyond the executive's tenure with the company.

Recommendation 15: Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business.

11.13 Many of our comments about executive bonuses apply to bonuses awarded to asset managers. Most asset managers are already trying hard to make money for their clients. Just as skilled employees in all sectors gain financially from reputation through promotion and competition for their services, so successful asset managers gain by attracting business and are sought after by other asset management firms. As with corporate managers, the probable effect of any performance incentive is not so much to make the person or business try harder as to make them try differently. Bonuses should achieve alignment of the interest of the manager with the interests of the client in the long-term absolute return on the fund.

11.14 Ideally, an asset manager would be remunerated by drawing his rewards almost wholly from the value of his holding in the funds under his control, thereby ensuring that his short and long-term interests are identical to those of the savers whose money is invested in his fund.

11.15 Few asset managers have initial wealth sufficient to enable them to pursue this structure, although many hedge fund managers and some private equity managers do have significant personal commitment alongside their investors. In the case of hedge funds, however, this personal commitment is usually in conjunction with a charge based on a percentage of assets under management and a performance fee. In private equity the gains from personal investment in the fund, if such investment exists at all, will sit alongside a management fee, a carried interest and often a performance fee.

11.16 Our concern, however, is primarily with the remuneration of managers employed in the long-only, or predominantly long only, stewardship activities we regard as critical to the equity investment chain.

Recommendation 16: Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund.

11.17 We do not believe that the Government or regulatory authorities should mandate the structure of remuneration packages for company directors or asset managers. In line with the general approach of this Review we would like to see a shift in practice driven by the application of fiduciary standards throughout the equity investment chain and by the statements of good practice we have set out for company directors and asset managers.

11.18 Some asset managers (typically those in large firms or in subsidiaries of large financial institutions) are subject to the FSA Remuneration Code which itself reflects recent EU legislation. The requirements the code imposes seek to counter incentives to excessive risk taking in institutions whose failure might pose systemic risks to financial markets. They require that a significant portion of performance based remuneration should be linked to the overall performance of the firm. We do not underestimate the significance of systemic risks in the financial system, but they do not to any substantial extent arise from the potential financial failure of asset management firms. Systemic problems in the asset management sector are likely to be the result of the failure of particular funds – as, notably, at Long Term Capital Management. The successful funds of a failed asset management firm will be rapidly acquired by another asset manager. To the extent that EU and domestic regulatory authorities do regulate asset managers' remuneration, they should seek to align the incentives of asset managers with the long-term performance of the funds they manage.

11.19 In Chapter 5 we addressed a key problem in the investment chain: how to ensure that the business imperative of the asset management firm – essentially, to grow assets under management – is consistent with good long-term decision making in the interests of companies and savers. A similar issue of potential misalignment of incentives arises at every point in the investment chain.

11.20 The misalignment of incentives between financial advisers of retail clients and their customers which is created by commission payments has been a central issue in the financial services industry for many years, and is finally being addressed in the RDR, which we discuss further in Chapter 12 below. However even if the sources of commission bias are removed, fee-based financial advisers will still have a bias towards action. It requires strength of character to advise a client to do nothing, and few clients will pay much for that advice.

11.21 Bias towards action is an inescapable feature of a transactions based system of intermediation. The bias to action is common to investment consultants and corporate advisers. The most effective offset to this is to favour a relationship based style of dealing over a transactional one; but this depends on effectively transmitting that perspective down to the principals dealing with the client.

11.22 The IMA correctly drew to our attention that of all participants in the investment chain, the asset manager was least vulnerable to such bias, because the remuneration of the asset manager is primarily based on the size of funds under management[43]. But, as we have discussed previously, the asset management sector has issues of incentive misalignment of its own. If these can be managed, however, enhancement of the role of asset managers has the potential to reduce misalignment of incentives substantially.

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[43] The Kay Review of UK Equity Markets and Long-Term Decision Making, IMA Response, November 2011, at: http://www.investmentuk.org/assets/files/consultations/2011/20111123_KayReview.pdf.

12 Regulating equity markets

Principle

The regulatory framework should enable and encourage companies, savers and intermediaries to adopt investment approaches which achieve long-term value by supporting and challenging corporate decisions in pursuit of long-term value.

Directions

It follows from these principles that:

- **Regulation should adopt the perspective and interests of market users, not market intermediaries. Market users are companies and savers**
- **Regulation should emphasise issues of structure and incentives rather than control of behaviour**
- **Regulation should not be based on the assumption that markets will achieve efficient outcomes if supplied with sufficient information, but whenever possible address policy objectives directly**
- **Regulation should be more consumer focussed, emphasise and promote simple products and trusted providers, stressing product suitability and supplier integrity**
- **Government and regulatory policy should aim to ensure that there are no unnecessary disincentives to using equity markets, either for companies or for their investors**
- **Regulatory requirements based on inappropriate metrics which discourage equity investment should be reviewed**

12.1 Our respondents complained – frequently and at length – about the burden of regulation, although they were rarely able to identify specific components of the regulatory regime which they thought should be removed. Many were sceptical about the effectiveness of current regulatory structures in achieving their objectives. At the same time, there is wide public and political demand for more regulation of the financial sector.

12.2 But the range and scale of failures in the financial system since 2008 in Britain, the United States and in continental Europe has demonstrated that the inadequacies of regulation lie in inadequacies of design rather than deficiencies in implementation. In a number of speeches and reports, Lord Turner, Chairman of the Financial Services Authority since 2008, has argued for a shift in regulatory philosophy which would ‘focus on business models, strategies, risks and outcomes than primarily on systems and processes’[44].

12.3 We agree with his diagnosis and approach, and hope that it will be fully taken on board in the early work of the PRA and (especially) the FCA. We would also urge that these ideas are implemented by the European Commission and others involved in the design of European financial services regulation.

12.4 We do not seek either more or less regulation. We expect that the long-run outcome of our approach would be less regulation, although measures to encourage or enforce structural reform in financial services may involve transitional costs, as with the measures proposed by the Independent Commission on Banking.

12.5 Transitional costs are also imposed by the RDR, whose central provisions – a ban on commissions to financial advisers – come into effect in 2013. These proposals for retail market reform are designed to promote structural change in the savings industry, and their potential impact on savers in UK equity markets may represent the most important regulatory change in a generation. This Review welcomes RDR and, in view of the significance of the changes it represents, does not recommend any further regulatory changes in this sector until the impact of RDR can be assessed. We would urge, however, such fuller consideration should be in line with the regulatory philosophy defined above. With its emphasis on structure and incentives, the RDR itself is consistent with that philosophy.

12.6 We have some concern that a likely consequence of the RDR will be the entrenchment of another layer of intermediation (the platform) in the already lengthy equity investment chain that links saver to company. The principal service platforms provide to savers – the opportunity to consolidate holdings in one place – is one which can be very inexpensively provided in other ways. We are concerned by the general trend to additional intermediation, each additional stage adding to costs and creating new possibilities of misalignment of incentives. We note that the FSA is currently consulting on banning payments by product providers to platforms and cash rebates to consumers, which may address this problem.

12.7 Most savers will wish to use intermediaries in making investment decisions, and should. The establishment of NEST as a channel for the intermediation of pension savings, although it represents the creation of yet another intermediary, is an important step in the evolution of the UK savings market. By virtue of its constitution NEST is well placed to win the trust of its customers. The expansion of NEST, and competition with NEST, should be a contribution towards building the trust and respect in the investment chain which is central to our approach.

12.8 Poor returns and high costs have discouraged equity investment. But it is important to British business and to the savings of British citizens that equity investment is sustained and provides strong returns. RDR is creating downward pressure on charges, and we hope that the recommendations we have made, especially on transparency, will reinforce this effect. We also hope that, in the long-run, the measures we propose will help both to reduce intermediation costs and to enable British companies to earn higher returns for their investors.

12.9 The Review believes that companies should as far as possible make decisions about appropriate financial structures on the basis of the intrinsic costs and risks associated with alternative means of financing. Similarly savers, advised as appropriate, should make decisions about the allocation of their savings on the basis of the intrinsic merits of different instruments and the risk/return characteristics

[44] Financial Services Authority: The Turner Review – A Regulatory Response to the Global Banking Crisis (March 2009) 003289 http://www.fsa.gov.uk/pubs/other/turner_review.pdf

they offer. Government policies should not have the object or, as far as possible, the effect of imposing particular choices on either companies or savers.

12.10 Measures affecting pension funds and insurance companies have in the last decade significantly discouraged commitment to equity markets. In the pension sector, the combination of mark to market accounting and more rigorous scrutiny of pension fund deficits has – in combination with the maturity of the sector and the popularity of liability driven investment strategies – brought about such discouragement. The Solvency II directive for insurers has had a similar consequence in the insurance sector. The possible extension of Solvency II principles to pension funds is a matter of particular concern.

12.11 It is in the nature of all investment activity that there should be a trade off between risk and return. But in both the pension and insurance sectors, the detriment to potential returns may exceed the value of reduction in risk to beneficiaries. In any event, such a calculation of costs and benefits to savers has not been central to the appraisal of the measures affecting insurers and pension funds which we have described. The concept of risk that has motivated these measures is, insofar as it is a relevant risk measure at all, in large part a measure of the risk to other institutions in the sector (and ultimately taxpayers) who share responsibility for the failure of a pension scheme or insurer.

12.12 Many respondents drew our attention to the tax discrimination which favours debt over equity. Although this discrimination is real, it is of long standing and is currently smaller than for many years: we do not believe that it is primarily responsible for the decline in the role of equity financing in the corporate sector. Moreover measures to address such discrimination would necessitate a fundamental reappraisal of the structure of corporation tax, best done in an international context.

12.13 Representations were also made to us on the role of capital gains tax. There has been repeated tinkering with the structure of this tax over the last two decades. That tinkering does not seem to have been an important influence on the development of equity markets. Capital gains tax is in fact paid only by a small proportion of holders of UK shares.

12.14 The proportion of shares in UK companies held by private individuals has, as we have noted, fallen steadily and we do not anticipate that this trend will be reversed. While some personal shareholders are traders, most are investors with real interest in the companies in which they invest. Direct shareholding should not be discouraged and it should be as easy as possible for small shareholders to maintain contact with companies.

12.15 Since the establishment of CREST in the 1990s, it has become increasingly common for retail investors to hold shares through omnibus nominee accounts. Although some private client brokers offer the alternative of CREST personal membership to their clients, most execution only stockbrokers require their clients to use these nominee accounts. The 2006 Companies Act provided a right for holders using nominee accounts to access company information, but these rights are not widely used even through the brokers who make them easy to exercise. ISAs, the tax exempt savings vehicle for private individuals, allow shareholding only through nominee accounts.

12.16 We regret that equity markets have evolved in a way which diminishes the sense of involvement which savers enjoy with the companies in which their funds are invested. We are also concerned about the security of nominee holdings. Although nominees are required to segregate holdings from those held for the benefit of the nominee company and its associates and to maintain appropriate records for omnibus accounts, recent events have shown that similar arrangements cannot necessarily be relied on in times of extreme stress.

12.17 Other jurisdictions which have dematerialised securities holding, such as Australia, Hong Kong and Sweden, have made arrangement to facilitate direct access by individuals. When CREST was first introduced, only a minority of shareholders could operate their accounts electronically. Now that internet access is widespread this is not the case and it is important to ensure that investors holding shares electronically can continue to enjoy the same opportunities for engagement with companies as they have done in the past, whether they hold those shares either directly or through an intermediary.

Recommendation 17: The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.

13 Markets for users

13.1 The financial system has been transformed since the 1970s by globalisation, deregulation, and reregulation. These developments changed the culture of UK financial institutions and the identity and behaviour of the leading participants. A culture which had emphasised trust relationships was replaced by one which gave primacy to trading. The trading culture has influenced the behaviour of market users – companies and savers – as well as market intermediaries. In the long run, the outcome has benefitted market participants more than market users.

13.2 We therefore seek to restore the balance. If we believe that some changes in the structure of the financial services industry have been for the worse, not for the better – and we do – we can recognise that mistakes have been made without relapsing into nostalgia for an imagined golden age. Our objective is to re-establish the primacy of trust relationships at all points in the equity investment chain, and to support the development of a cooperative rather than a trading culture.

13.3 British companies now rarely use primary equity markets as a source of funds for new investment: if they raise new equity at all, it is usually as part of some financial restructuring. The IPO is no longer the normal aspiration of a fledgling business. As UK business has retreated from the primary equity market, financial institutions have filled the gap by promoting issuance in London on behalf of foreign companies, mostly unconnected with UK business and often of disappointing quality.

13.4 Despite the decline in the significance of primary issuance, quoted companies pay far more attention to equity markets and their share prices than in the past: investor relations and the management of market expectations, activities which once barely concerned senior company executives, are now an important part of their job. The financialisation of companies has put these managers under pressure to 'do the deal' and 'make the numbers', sometimes at the expense of the development of the capabilities and competitive advantages of their operating businesses.

13.5 Savers did well in the early stages of the process of change in the financial sector. In the 1980s and 1990s the share of profits in national income increased and high levels of market activity helped to boost share prices. But the new economy bubble proved a watershed, and was followed by the 2007-8 financial crisis. The period since the millennium has provided poor equity returns overall and considerable market volatility. Disenchanted long-term savers have reduced their equity allocations.

13.6 For a time, savers – or their agents – were attracted by 'alternative' investments, particularly hedge funds and private equity: but increasingly these investments came simply to represent more costly means of obtaining access to the same corporate assets which long-term savers had always held. As UK savers and asset holders have turned away from equity investment in British business, an increased proportion of their funds has been allocated to bonds even though yields have been driven down to levels with no recent historical precedents.

13.7 At the same time, market participants have prospered. Asset management firms have grown in scale and profitability. The remuneration of investment bankers and traders has reached levels which are the subject of regular attention in popular media. The volume of activity in, and the complexity of, financial markets has continued to increase. The crash of 2007-8 meant that the shareholders of banking conglomerates lost much of their investment, but the pay of senior executives in these institutions has remained extremely high

13.8 In equity markets today we observe high volumes of trading between individuals – or computers – who deal anonymously with each other, and know little or nothing about the activities of the companies whose shares they trade. It is hard to see how this activity could contribute much to well judged capital allocation between corporate activities or to good governance in the corporate sector, and we found no reason to think that it has done so. Nor can such a trading environment generate the information needed either to make good long-term decisions in companies or to assess whether good long-term decisions have been made.

13.9 The process of price discovery, on which some market participants put great emphasis, is based on an understanding of order flow and of the expectations of other traders. Such a process of price discovery is distinct from the process of value discovery. Value discovery is the research and analysis which attempts to establish the nature and sustainability of the long-term competitive advantages of the business.

13.10 Many respondents correctly emphasised that the provision of liquidity is a primary function of equity markets. Trading in markets is essential if the time horizon of savers is to be allowed to differ from the time horizon of corporations. But it does not follow that the degree of liquidity is the proper measure of the effectiveness of equity markets – whatever, exactly, liquidity means: these respondents tended to assess liquidity by the size of the trading spread. But the economic significance of liquidity is the ability of investors to realise significant stakes in a medium term time scale at realistic prices, and to do so even in turbulent market conditions. The difference between the price at which a share can be simultaneously bought and sold, typically in modest quantity – a transaction which no investor will ever undertake – is a poor guide to that measure of liquidity.

13.11 Regulatory philosophy has increasingly been based on a model of markets which emphasises trading over trust relationships. Regulation has been framed to excessive degree with the concerns of market intermediaries rather than market users in mind. It is a measure of priorities that regulation admits, even encourages, market participants to gain an advantage over others by reacting more quickly to data, but prohibit market participants from gaining an advantage over others by obtaining better information. Equity markets should be seen as a means of contributing to the performance of business, not as a game in which all competitors race for relative advantage when the starting gun is fired.

13.12 We reiterate that the effectiveness of British equity markets is best measured by the impact on the long-term performance of the companies which list on these markets. That long-term performance is, in the long run, the only source of the returns that long-term savers seek and require.

13.13 Our long-term goal is to rebuild the equity investment chain on the basis of trust relationships, both between savers and their agents, and between these agents and investee companies. The re-establishment of trust in the financial services sector is not a matter of dispelling false public perceptions. The erosion of trust is the product of an objective reality, an inevitable effect of the substitution of impersonal trading relationships for long-term trust relationships. Only changes in culture and behaviour can restore that lost trust.

13.14 The recommendations in this report have two strands. In the long-term, we seek a new model of equity investment, sustained by a new regulatory philosophy. We visualise a shorter equity investment chain, in which the central figure is the asset manager, who develops trust relationships with the – narrower than today – range of companies in which he or she chooses to invest. In this model the role of the asset manager vis-à-vis the company is akin to that of the mentor, who will provide reaction and advice but does not assume or second guess managerial responsibility. This is very different from the role of the bystander who walks away when he does not like what he sees, or the police officer who intervenes only on request or when attracted by improper behaviour

13.15 In the model of the equity investment chain we visualise, the asset manager competes for funds, not by participating in a contest based on recent short-term performance figures, but by persuading savers and asset holders of the long-term merits of a distinctive investment approach. We expect the volume of trading would be less, and probably far less, than it is today.

13.16 We have also made a series of recommendations which, in the short term, should move behaviour in the directions we suggest. We have tried to avoid prescriptive regulation wherever possible in framing these recommendations. We believe the lesson of recent financial crises is that the cultural changes we seek can be achieved only by changing the structure of the industry and the incentives of those who work in it, not by ever more prescriptive rule books of behaviour.

13.17 To achieve these outcomes, major changes are required in the approach of asset holders and asset managers. Such thinking leads us to emphasise the promotion and development of good practice statements and the encouragement of collective action by fund managers. We also look for a profound change in regulatory approach, emphasising that regulation must be directed towards the interests of market users – companies and savers – rather than the concerns of market intermediaries. At the same time, we seek to aid the rebuilding of trust by re-emphasising the fiduciary obligations of participants in the investment chain.

13.18 The task of recreating an equity investment chain that meets the needs of users and that is based on trust, respect, confidence and cooperation, will be long and difficult. But it is time to begin.

Appendix A: Contributors to the Review

The Review Advisory Board

During the Review, I was grateful for the support of the Advisory Board. I would like to thank them for their time, input and knowledge, which has been invaluable.

- Sir John Rose, former Chief Executive of Rolls-Royce plc
- James Anderson, Partner at Baillie Gifford and Manager of the Scottish Mortgage Investment Trust, and
- Chris Hitchen, Chief Executive of the Railways Pension Trustee Company and Chairman of the Pensions Quality Mark.

Friends of the Review

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- Professor Amar Bhidé, The Fletcher School of Law and Diplomacy – Tufts University
- Andrew Haldane, Bank of England
- Brian Sturgess, World Economics
- David Pitt-Watson, Deloitte Consulting and Hermes Pension Management Limited
- Eric Beinhocker, Executive Director, the Institute for New Economic Thinking at the Oxford Martin School, University of Oxford
- Professor Gordon Clark, University of Oxford
- Harlan Zimmerman, Cevian Capital
- Henrietta Marsh
- James Macpherson, BlackRock
- James Palmer, Herbert Smith LLP
- Julian Franks, London Business School
- Lindsay Tomlinson, NAPF
- Mary Francis CBE, Senior Independent Director, Centrica plc
- Neil Woodford, Invesco Perpetual
- Paul Marsh, London Business School

- Paul Woolley, London School of Economics and Political Science
- Peter Vipond, FSA
- Dr. Philip Augar, British author and a former Group Managing Director at Schroders plc
- Professor Eilis Ferran, Faculty of Law, University of Cambridge
- Professor John Armour, Oriel College, University of Oxford
- Sir Richard Lambert, Chancellor of the University of Warwick and former Director-General of the CBI
- Sir Terry Leahy, Former Chief Executive of Tesco
- Stephen Davies, Senior Fellow, Harvard Law School Program on Corporate Governance and Nonresident Senior Fellow, the Brookings Institution
- Tony Broccardo, Barclays UK Retirement Fund.

Appendix B: Evidence submitted to the Review

I would like to thank all who responded to the Review. Many individuals responded as well as the following organisations.[45]

A
Anglia Ruskin University
Aon Hewitt Investment Consulting
International Capital Markets Association: Asset Management and Investors Council
Association for Financial Markets in Europe
Association of British Insurers
Association of Chartered Certified Accountants
Association of Corporate Treasurers
Association of Private Client Investment Managers & Stockbrokers
Aviva Investors

B
Barclays
BlackRock
Brewin Dolphin
BT Pension Scheme Management Ltd

C
Capita Registrars
Carbon Tracker Initiative
Cazenove Capital Management
Cevian Capital
CFA Society of the UK
Church of England Ethical Investment Advisory Group and National Investing Bodies
City of London, City Office (ISRG)
City of London, Law Society (Company Law sub-committee)
Civitas
Co-operative Asset Management
Computershare Investor Services PLC
Confederation of British Industry
CrossBorder Capital

E
Equiniti
Euroclear SA/NV within the Euroclear group
Europapartners

F
FairPensions
Fidelity International
Finance Watch
Financial Reporting Council
Financial Services Consumer Panel
FTSE Group
Fundamental Tracker Investment Management Ltd

[45] Eight respondents requested that their responses be kept confidential.

G
Governance for Owners

H
Hermes Equity Ownership Services Ltd
Human Potential Accounting
Hundred Group of Finance Directors

I
Institute of Chartered Accountants in England and Wales
Institute of Chartered Accountants of Scotland
Institute of Chartered Secretaries and Administrators (Registrars Group)
Institute of Directors
International Securities Lending Association
Invesco Perpetual
Investec Asset Management
Investment Management Association
Investor Relations Society (IR Society)
Investor Stewardship Working Party (The Centre for Tomorrow's Company) – Working Party Group

K
Kames Capital
KPMG

L
Legal & General Investment Management
Local Authority Pension Fund Forum
London Stock Exchange Group
Long-Term Practical Perspectives Ltd

M
M&G Ltd.
MM&K Ltd
MAM Funds plc
Manifest
J.P. Morgan Asset Management

N
National Association of Pension Funds
Network for Sustainable Financial Markets

P
PricewaterhouseCoopers LLP

Q
Quakers and Business Group
Quoted Companies Alliance

R
Royal London Asset Management
RPMI Railpen Investments
RWC Partners Ltd

S
Schroders Investment Management Ltd
Share Centre
Society of Pension Consultants
Sources of Value
Standard Life Investments Ltd
State Street Global Advisors Ltd
SVM Asset Management Ltd

T
Taylor Wessing LLP
The Takeover Panel
Tomorrow's Company (The Centre for)
Trades Union Congress
Tradeworx

U
UBS Global Asset Management (UK) Ltd
UK Individual Shareholders Society Ltd (ShareSoc)
UK Shareholders’ Association, The (UKSA Government Policy Group)
UK Sustainable Investment and Finance
University of Bath
University of Edinburgh Business School
Universities’ Superannuation Scheme

Appendix C: Glossary

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

Capital Asset Pricing Model (CAPM):
http://financial-dictionary.thefreedictionary.com/Capital+Asset+Pricing+Model

Competition Commission (CC):
http://www.competition-commission.org.uk/

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

Interim Management Statements – UKLA Technical Note:
http://www.fsa.gov.uk/pubs/ukla/ims_review.pdf

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

Markets in Financial Instruments Directive (MiFID)
http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm

Retail Distribution Review (RDR), Financial Services Authority (FSA):
http://www.fsa.gov.uk/rdr

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

Takeover Code – the City Code on Takeovers and Mergers:
http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf

The Pensions Regulator:
http://www.thepensionsregulator.gov.uk

UK Corporate Governance Code (and 'comply or explain'):
http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/The-UK-Approach-to-Corporate-Governance.aspx

UK Listing Authority (UKLA), part of the FSA:
http://www.fsa.gov.uk/Pages/doing/ukla/index.shtml

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