FairPensions
The campaign for **responsible** investment

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FairPensions Written Evidence to BIS Select Committee Inquiry into the Kay Review of UK Equity Markets

Summary

- The Kay Review correctly concludes that there is a mismatch between the long-term interests of savers such as pension funds and the short-term incentives of the investment intermediaries managing their money.
- Ways of addressing this misalignment include legal mechanisms (i.e. fiduciary duties), financial mechanisms (i.e. remuneration design) and market mechanisms (i.e. consumer pressure & accountability). The Kay Review makes strong proposals on the first two of these three, but has less to say about the third. This is an area which would benefit from further policy intervention, for example to strengthen savers' rights to information about their investments.
- We strongly welcome the Kay Review's proposals on investors' fiduciary obligations:
    - Clarification of *what* these duties mean – in particular, that they do not oblige fiduciary investors to maximise short-term profits at any cost – is overdue. We support the decision to refer this matter to the Law Commission, which we hope and expect will be empowered to recommend statutory clarification.
    - Kay is right to argue that fiduciary standards of care should apply to all those managing other people's money. We are pleased that the government accepts this in principle, but have some concerns that the wording of its revised Good Practice Statements may inadvertently water down the standards to be applied.
- The Stewardship Code is an important vehicle for promoting long-term, responsible ownership by institutional investors. It has so far been very successful in gaining acceptance by the investment industry, but less successful in generating demonstrable behaviour change. We believe its potential could be enhanced by:
    - strengthening the Code in a number of areas, e.g. management of conflicts of interest, attention to systemic risk, and emphasis on factors beyond financial results;
    - providing for independent monitoring of adherence to the Code's principles, to be reported to parliament annually; and
    - building the capacity of pension funds and underlying pension savers to hold their investment agents to account for their stewardship activity.
- We agree with Kay that 'high quality, succinct narrative reporting' is an important tool to enable investors to engage on issues of long-term strategy. We are concerned that the government's current proposals are unlikely to make any significant difference to the quality of reporting.

About FairPensions

1. FairPensions is a registered charity that works to promote active share-ownership by institutional investors in the interests of their beneficiaries and of society as a whole. Our particular focus is on encouraging shareholder engagement with listed companies to ensure effective management of environmental, social and corporate governance (ESG) risks which may affect long-term financial returns.

2. We are a member organisation. Our members include bodies representing pension savers, leading UK charities and thousands of individual pension fund members. We are independent of industry and are funded primarily by grants from charitable foundations and trusts.

3. FairPensions has been closely involved with the Kay Review from its inception through to the government's response. In particular, our research on institutional investors' fiduciary duties has been influential in shaping the Review's recommendations. Accordingly our evidence focuses on the Review's recommendations regarding fiduciary duty, although we also comment on other areas which fall within our expertise.

Introduction: Analysis of the problem of short-termism

4. We agree with the Kay Review's analysis that resolving the problem of short-termism is not simply a matter of enhancing the influence of 'long-term' investors (such as pension funds) and stemming the rise of 'short-term' investors (such as high frequency traders). Rather, there are underlying structural problems with equity markets which cause theoretically long-term investors to behave in a short-term way.

5. Likewise, we agree that promoting more effective 'stewardship' of companies by investors is not simply a matter of encouraging more shareholder engagement. For instance, in the run-up to the financial crisis, shareholder engagement with major financial institutions was not simply insufficient but actively damaging. Increased leverage and short-termist business models were often justified in the name of shareholder value, and (as far as we can ascertain) only one major asset manager voted against the takeover of ABN-AMRO by RBS.

6. In the recent FRC review of the Stewardship Code, many companies felt that "*some shareholders still seemed to focus too much on specific issues of a short-term nature*".[1] Similarly, in a survey of ten large European pension funds, the funds estimated their ideal time horizon at 23 years and their actual time horizon at six years.[2] There is clearly a misalignment between the inherently long-term financial interests of pension savers and the often short-term outlooks of those managing their money.

7. There are three complementary mechanisms for addressing this 'principal/agent' problem:

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[1] FRC, December 2011, 'Developments in Corporate Governance 2011: The impact and implementation of the UK Corporate Governance and Stewardship Codes'. Available at http://www.frc.org.uk/images/uploaded/documents/Developments%20in%20Corporate%20Governance%202011 6.pdf

[2] Hesse, 2008, 'Long-term and sustainable pension investments: A study of leading European pension funds' . See http://bit.ly/uaPQdd

- Legal mechanisms: ensuring that all those managing other people's money have fiduciary duties to act in their best interests, and that these duties are understood in a way which promotes those interests over the long-term;
- Remuneration: ensuring that the pay of investment intermediaries is structured in a way which aligns with the long-term interests of beneficiaries and does not create perverse incentives to focus exclusively on short-term share price movements; and
- Consumer pressure: forging a stronger link between investment institutions and underlying savers, so that those with a real interest in long-term performance are able to hold their agents to account directly. This parallels the government's approach to executive pay, which has focussed on giving shareholders the tools to hold managers to account.

8. In our view, the Kay Review's recommendations are strong on the first two of these three levers: we particularly welcome moves towards clarification of institutional investors' fiduciary duties. The Review has less to say about the third lever; this is an area which would benefit from further policy thinking.

1. Fiduciary duties

a. Clarifying the content of fiduciary duties (Recommendation 9)

9. We welcome the Kay Review's recommendation for a Law Commission review of the application of fiduciary duties to investment. Pension fund trustees have a fiduciary duty to act in the best interests of their beneficiaries. (The extent to which similar duties apply to other investment intermediaries is discussed below.) This duty should be part of the solution to short-termism in equity markets, but it has too often been part of the problem.

The problem
10. Fiduciary investors tend to assume that their legal duties begin and end with maximising returns, and this in turn tends to be interpreted in terms of short-term returns relative to a benchmark. In our experience, this contributes to an excessive focus on short-term share price movements and to the neglect of factors which are not easily monetisable, including:

- environmental, social and governance (ESG) factors with implications for companies' long-term financial value;
- systemic risks (be it risky lending in the financial sector or the implications of climate change) with potential financial impacts that far outweigh the effects of individual funds' relative performance; and
- non-financial factors, such as beneficiaries' ethical views or the implications of investments for their quality of life or community.

11. Some examples of this problem from our own experience include:

- One large UK pension scheme was given legal advice suggesting that their policy of exercising voting rights could breach their fiduciary duties if they could not demonstrate that the costs incurred were justified by monetisable benefits to that individual scheme. Since the benefits of stewardship almost

inevitably accrue to the market as a whole, this contributes to a 'free-rider' problem which holds back the shift towards a stewardship culture.
- We are aware of fund managers who lost contracts in the 1990s because they saw the 'dotcom bubble' for what it was and refused to invest in tech stocks. Although with hindsight this was clearly a prudent long-term strategy, it led such managers to underperform their peers in the short-term. Many pension funds assumed they would be failing in their fiduciary duties if they did not respond to this by hiring a more orthodox manager. It is not unreasonable to suppose that some funds may have suffered loss as a result.
- One officer of a multi-employer pension fund recounts seeking legal advice on whether, when voting on a hostile takeover, they could take account of the fact that some of their beneficiaries might lose their jobs. The response was that this was not a relevant consideration: the trustees' fiduciary duty bound them only to consider the price they would be paid for their shares.

Response to the Kay Review's proposed solution

12. FairPensions has advocated statutory clarification to confirm that institutional investors *may* have regard to a wider range of factors than is commonly assumed. We have produced draft legislation illustrating how this could be done, modelled on section 172 of the Companies Act 2006 which sought to achieve a similar objective in relation to company directors. The Kay Review agreed 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*", but proposed that the matter be referred to the Law Commission. We support this course of action, provided that:

- the review is conducted in a timely manner, with steps taken to minimise any 'chilling effect' on investor behaviour in the meantime (for instance, by reiterating and publicising the government's view that the law does allow wider scope for discretion than is often assumed); and
- the Law Commission is empowered to recommend statutory clarification if it concludes that this is necessary, with a clear presumption in favour of speedy implementation of any legislative proposal.

13. In our experience, narrow interpretations of the law are reinforced by cautious legal advice, perpetuated by a lack of relevant case law, rather than simply being the result of trustee misunderstandings. We find it difficult to see how this problem will be resolved without express clarification of the law.

b. Clarifying the scope of fiduciary duties (Recommendation 7)

14. Kay also argues that short-termism is related to the replacement of relationships based on trust and confidence with a 'transactional' trading-led culture, and that reasserting fiduciary standards will help to refocus equity markets on the long-term interests of savers rather than those of financial intermediaries. We agree that all those managing other people's money should be held to fiduciary standards of care, and that – combined with action to address misinterpretations of fiduciary duty, as discussed above – this should help to promote long-termism.

The problem

15. Fiduciary duties exist to ensure that those acting on behalf of others keep their best interests at heart. Yet there remains some confusion about who fiduciary duties apply to. While it is clear that pension fund trustees are fiduciaries, the status of many others who look after savers' money is less clear-cut:

- There appears to be a growing consensus that asset managers are subject to fiduciary duties: the Law Commission has concluded that "*in general a firm advising a customer or making purchases on a customer's behalf will be acting in a fiduciary capacity."*[3] However, this is still not undisputed, and asset managers often use the term 'fiduciary' to describe a general duty of care towards clients rather than to indicate acceptance of the strict obligation to put beneficiaries' interests first.
- Insurance companies (who are responsible for an increasing proportion of the nation's pension savings) are generally held not to have fiduciary duties. This is largely because individuals saving with an insurance company are not the 'beneficial owners' of the assets invested: instead the assets are owned by the insurance company, with the saver's rights over them arising from their contract with that company. However, the economic relationship is essentially the same: one person is still entrusting their money to another for investment purposes.

16. It has been argued that debates about the extent of fiduciary duties are a legalistic irrelevance, since FSA rules (including those stemming from European regulations such as MiFID) already require investment intermediaries to act in the best interests of their clients. This is misleading. As the Law Commission has observed, *"there are many instances where regulatory rules permit... a lower standard of conduct than that required by fiduciary law."*[4] For example, fiduciary duties require *"single-minded loyalty"* to beneficiaries,[5] while FSA rules merely require that firms pay *"due regard"* to the interests of their customers. Similarly, fiduciaries are required to avoid conflicts of interest wherever possible, and where impossible, to ensure that they are always resolved in the interests of the beneficiary. FSA rules require only that *"a firm must manage conflicts of interest fairly"*. Balancing the interests of consumers with the interests of the firm is a very different proposition from single-mindedly putting consumers' interests first.

17. In our view, these legal differences do indeed have practical implications. There is considerable anecdotal evidence that conflicts of interest among fund managers are a barrier to more robust shareholder engagement. For example, one recent paper cites an instance where "*the company secretary of a UK manufacturer reminded a fund manager who was intending to vote against the company's remuneration report that his firm was bidding for an investment mandate from the corporation's pension plan*".[6] In financial conglomerates, conflicts may also arise between asset management arms and investment banking arms.

[3] Law Commission, 1992, 'Consultation Paper No. 124: Fiduciary Duties and Regulatory Rules' (HMSO), para 2.47
[4] Law Commission, 1995, *'Fiduciary Duties and Regulatory Rules'*, (HMSO), para 1.8
[5] Bristol and West Building Society v Mothew [1996] 4 All ER 698
[6] Wong, S., 'How conflicts of interest thwart institutional investor stewardship', Butterworths Journal of International Banking and Financial Law, Sept 2011

18. When we surveyed asset managers' disclosures under the Stewardship Code, we found that many gave little or no insight into how conflicts were managed.[7] To take a specific example, in the recent 'Shareholder Spring', both Aviva and Prudential suffered high profile rebellions on pay. Aviva Investors' conflicts of interest policy sets out clear procedures for when and how it will vote shares in Aviva plc.[8] M&G (the asset management arm of Prudential) has no such policy. In accordance with its policy, Aviva Investors did not vote on Aviva plc's remuneration report unless in accordance with explicit instructions from clients. M&G voted in favour of Prudential's controversial remuneration report; its voting disclosures provide no explanation of this decision or of how this conflict of interest was managed. The FRC and FSA[9] have also identified conflicts as an area for improvement.

Response to the Kay Review's proposed solution

19. The Kay Review recommended that "*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"*. Whilst accepting the thrust of Kay's recommendation, the government's response stated that it has *"elected to avoid using the word 'fiduciary'"*, citing confusion over the scope of the term. In our view, the prevalence of conflicting assumptions about the scope of fiduciary obligation is precisely why this area of the law ought to be clarified.

20. However, even if the government chooses not to explicitly use the word 'fiduciary', the most important thing is that the standards of care which it promotes are equivalent to fiduciary standards. In our view, the wording of the government response creates – presumably unintentional – ambiguity on this front. The revised 'good practice statement' does not explicitly assert the duty of undivided loyalty to clients / beneficiaries, stating only that "*conflicts of interest [should be] avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary."* This would seem to imply that merely disclosing the existence of a conflict of interest is equivalent to managing that conflict in accordance with beneficiaries' interests. In our view, this is not the case and does not tally with fiduciary standards.

21. We are very pleased that the government has asked the FSA/FCA to assess the extent to which its rules align with the 'fiduciary-like' principles it has outlined. However, we are concerned that the wording of those principles must be clarified and refined, since the current wording obscures the very issue (i.e. conflicts of interest) where the difference between FSA rules and fiduciary duties is most significant. If this is not addressed, any FSA/FCA review could miss an important opportunity to meaningfully raise standards of consumer protection.

2. The Stewardship Code

22. The Kay Review recommends that "*the Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as*

[7] FairPensions, 2010, 'Stewardship in the Spotlight', p9, http://www.fairpensions.org.uk/sites/default/files/uploaded_files/whatwedo/StewardshipintheSpotlightReport.pdf
[8] http://www.avivainvestors.com/internet/groups/internet/documents/salessupportmaterial/pdf_024453.pdf
[9] http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf

well as questions of corporate governance". We agree that the Stewardship Code is an important vehicle for promoting investor long-termism, but have always regarded its principles as relevant to company strategy as well as corporate governance. Nonetheless, we believe there are other ways in which the Code could be improved, as outlined in our response to the FRC's recent consultation.[10] Accordingly, although we accept the government's view that this consultation has addressed Kay's specific recommendation, we do not think that this should mark the end of policymakers' engagement with the Code.

23. In particular, FairPensions has argued that the Code should:

- articulate more explicitly that engagement can and should extend beyond immediate financial matters and encompass drivers of a company's long-term fundamental value, including environmental, social and governance (ESG) factors. This would help to address complaints from company directors that shareholder engagement is still short-term in nature and focussed too heavily on quarterly financial results.

- address more explicitly the role of institutional investors, particularly 'universal owners' such as pension funds with holdings across the economy, in nurturing the wider economy and attending to potential systemic risks, rather than only engaging with risks to individual companies in their portfolio. Such systemic factors have far greater implications for returns to beneficiaries than the performance of any single company,[11] but this is not yet reflected in the way investors engage. The Stewardship Code could play a vital role in catalysing this cultural shift and overcoming the collective action problems which hold back engagement on systemic issues.

- be stronger and clearer in respect of conflicts of interest. As discussed above, our research finds this to be a consistent area of weakness amongst asset managers. The recent amendments to the Code, although welcome, do not seek to ensure that signatories explain how key conflicts of interest are managed in practice.

- articulate a clearer definition of 'stewardship'. Although steps have been taken in the most recent version of the Code to address this ambiguity, the Code still does not define the term 'stewardship' as such. In our experience, there is still confusion over what is being 'stewarded' (companies, savers' assets, or the economy and environment on which financial returns depend) and to whom stewardship obligations are owed (companies or savers).

24. We have also argued that the IMA's annual survey is not the appropriate vehicle for official monitoring of the Code's implementation, and that either the FRC itself or an independent academic institution should be resourced to undertake an independent annual survey. The FRC could also be required to report regularly to BIS on the Code's implementation, with such reports being laid before parliament. In our experience, the Stewardship Code has so far been commendably successful at gaining the support of the investment industry, but it is far from clear that this support is

[10] See http://www.fairpensions.org.uk/sites/default/files/uploaded_files/StewardshipCodeReview2012.pdf
[11] See for example Brinson et al, 1991, *'Determinants of Portfolio Performance II: An Update'*, Financial Analysts Journal vol 47, no. 3 (May/June): 40-48; Ibbotsen, *'The Importance of Asset Allocation'*, Financial Analysts Journal Vol 66 No 2 (March/April 2010)

translating into changed behaviour in practice. Effective, independent monitoring of whether progress is being made in this regard, made available to government and parliament, is an essential tool for policymakers to judge whether additional measures are needed.

25. Finally, policymakers must ensure that clients and beneficiaries are empowered to scrutinise the stewardship approaches of those who manage their money. This is essential if 'comply or explain' is to be effective, since it relies on bottom-up scrutiny as a substitute for detailed top-down regulation. For example, instead of listed companies' compliance with the Corporate Governance Code being enforced by regulators, it is overseen from below by shareholders (although the extent to which this actually takes place appears to be variable[12]). The parallel audiences for disclosures under the Stewardship Code are clients and beneficiaries: pension funds in the case of asset managers, and underlying savers in the case of pension funds themselves. But structural problems hold back effective scrutiny:

- Pension funds have so far been less keen than asset managers to engage with the stewardship agenda, with many not seeing it as a priority, and some even believing (as we have seen) that it falls outside the scope of their legal mandate. Clarification of fiduciary duties should help to address this.
- Individual savers are disconnected and disempowered: lack of understanding and an endemic lack of transparency and accountability makes it difficult for them to engage with what happens to their money. Policymakers should take steps to improve public disclosure (for instance, of voting records) and strengthen beneficiaries' rights to receive more detailed information on request.

3. The investor forum

26. Collective engagement is vital given the increasing dispersion of ownership. In addition, effective collective action should enable investors to engage with wider systemic challenges affecting returns across their portfolio (such as climate change), as well as engaging on strategy at individual companies.

27. It remains to be seen whether the establishment of an 'investor forum' as recommended by Kay will lead to a step change in this activity. At first sight it is unclear how this initiative will differ from previous and existing investor bodies, such as the Institutional Shareholders Committee (ISC).

28. Kay correctly identifies that misaligned incentives running through the system help to perpetuate short-termism. It is therefore somewhat surprising that his recommendations largely expect change to come from within that system (that is, through voluntary action from investment professionals, and asset managers in particular). In our view, it follows logically from Kay's analysis of the problem that some kind of external force must act on the system in order to shift the incentives of its participants onto a more long-termist, sustainable footing. This would seem to be a prerequisite for effective industry action on the scale Kay wishes to see.

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[12] See for example Arcot, Bruno & Grimaud, 2005, 'Corporate Governance in the UK: Is the comply-or-explain approach working?'

29. Such external action can come either from above (i.e. regulators) or below (i.e. clients and beneficiaries) or a combination of the two. However, experience suggests that at least one of these will be necessary: it will not be sufficient simply to expect the system to heal itself. Our recent report, *'The Missing Link: Lessons from the Shareholder Spring'*, provides further evidence of the disconnect between underlying savers and those who manage their money, and argues that policymakers should address this. Copies of this report have been provided to members of the Committee.

4. Narrative reporting

30. Robust, meaningful company reporting on factors affecting the long-term value of a business – including environmental and social factors – is a prerequisite for effective investor engagement on these issues. The 2010 Coalition Agreement included a commitment to *"reinstate an Operating and Financial Review to ensure that directors' social and environmental duties have to be covered in company reporting"*. This commitment originated in the Liberal Democrat Manifesto.

31. The key difference between the Operating and Financial Review (OFR) and the current Business Review was that the OFR required a higher standard of assurance (the 'enhanced audit'). It was our understanding that the coalition commitment reflected this key difference and that its intent was to ensure that companies produced narrative information which investors could rely on. We strongly welcomed this commitment, since anecdotally we hear that one reason investors do not heed such information is that it lacks rigour and verifiability.

32. However, it soon became clear that (apparently as a result of the government's policy of 'one-in, one-out regulation') there was little appetite for including enhanced audit standards in the new narrative reporting framework. Instead, the Business Review is to be replaced with a new 'Strategic Report' whose status and prescribed content is almost identical to that of the Business Review, except for a renewed emphasis on strategy for quoted companies. This is to be supplemented with an 'Annual Directors' Statement', although it is unclear whether this will be prescribed by regulation, and if so what its content will be.

33. In our view this package of reforms to narrative reporting does not meet the spirit of the coalition commitment. It contains nothing which we would expect to drive up the quality of social and environmental reporting – the key objective of the original commitment. We are also sceptical of the contribution it will make to Professor Kay's recommendation that *"high quality, succinct"* narrative reporting should be strongly encouraged – not least because it has little to say about what constitutes 'high quality' reporting. We understand that the FRC will shortly be consulting on revised guidance for companies preparing narrative reports. This may provide an opportunity to rectify this disappointing outcome.