Final Report of the Kay Review of UK Equity Markets & Long-termism

"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."
- Final Report of the Kay Review

Professor John Kay was commissioned by Vince Cable in 2011 to carry out a review of UK equity markets' ability to promote long-term performance of UK businesses and long-term returns to UK savers. The review arose from BIS' project 'A long-term focus for corporate Britain', which also led to the recently-announced package of measures on executive pay, and which has been central to the government's 'responsible capitalism' agenda.

The final report of the Kay Review was published on 23 July 2012. This briefing summarises its key conclusions and recommendations, and gives FairPensions' response to recommendations where we have expertise.

KAY'S ANALYSIS

The state of UK equity markets

Kay notes that equity markets are no longer a significant source of new capital for UK businesses: rather, their function is to allow savers to share in the success of business. The corporate governance function of shareholders is therefore not a sideshow but a core part of the purpose of modern equity markets.

> *"The effectiveness of modern equity markets depends almost entirely on their effectiveness in promoting … stewardship and governance."*

He also concludes that short-termism cannot simply be blamed on high-frequency traders or arbitrageurs, but rather stems from underlying problems which also affect theoretically long-term investors like pension funds and insurance companies.

In response to recent governance failings in banks and other listed companies, the consensus has been to blame insufficient shareholder engagement – the 'absentee landlord' problem. But Kay points out that many bad corporate decisions – like RBS' takeover of ABN-AMRO - "were supported or even encouraged by a majority of the company's shareholders". We need not just more engagement but the right kind of engagement. This means addressing the factors which cause long-term investors to behave in a short-term way.

> *"Shareholder engagement is neither good nor bad in itself: it is the character and quality of that engagement that matters."*

POLICY BRIEFING

The causes of short-termism

The report identifies two key drivers of short-termism in UK equity markets:

- the erosion of trust, and
- the misalignment of incentives.

Kay argues that the **erosion of trust** in financial services is not the result of public misconceptions, but *"the product of an objective reality, an inevitable effect of the* ***substitution of impersonal trading relationships for long-term trust relationships"***. An overarching theme of his recommendations is the re-establishment of trust relationships based on 'voice' rather than 'exit', underpinned by fiduciary standards of care.

Kay also criticises the influence of the Efficient Markets Hypothesis on both investors and regulators:

- the assumption that market prices reflect all available information about a company's prospects encourages investors to focus solely on share price movements, rather than assessing a company's fundamental value;
- a regulatory approach focussed on information disclosure, which is assumed to make markets work efficiently, has led to a constant bombardment of data – for example, quarterly reporting by companies – which drives investors towards short-term judgements about performance.

Finally, Kay argues that the erosion of trust has contributed to the proliferation of **financial intermediaries**, which "adds to the costs of the investment chain, and creates potential for **misalignment of incentives** at each link of the chain". He envisages a radically simpler market structure with asset managers being the key intermediaries between savers and the companies they own. He also argues that regulation should focus on creating the structures and incentives that will engender good behaviour, rather than trying to control the consequences of perverse incentives.

> *"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."*

KAY'S RECOMMENDATIONS

The Kay Report's Recommendations

The Kay Report makes 17 recommendations aimed at government, regulators and industry. These are summarised below.

- Regulators should apply fiduciary standards to all those managing or advising on other people's money.
- The Law Commission should review the application of fiduciary duties to investment to clarify what the law requires and permits.
- An investors' forum should be established to facilitate collective engagement.
- Mandatory quarterly reporting should be abolished.
- Asset managers should make full disclosure of all costs, including transaction costs, and of income from stock lending.
- Companies' and asset managers' pay should be structured in the form of an interest in the company or fund which must be held until after the director/manager has left the company/fund.
- The Stewardship Code should be developed to incorporate a broader form of stewardship encompassing company strategy as well as governance.
- BIS should keep the scale and effectiveness of merger activity under review.
- Government should commission an independent review of metrics and models in investment, and should avoid prescribing particular models of measuring risk which may have perverse consequences (such as 'mark-to-market' accounting).
- Government should explore ways of allowing individual investors to hold shareholdings directly on an e-register, rather than via intermediaries.

Fiduciary duties

Fiduciary duties are the strict obligations imposed on people entrusted to act on behalf of others (for example, lawyers and trustees). Fiduciaries are required to act in the best interests of those they represent, not to profit at their expense and to avoid conflicts of interest.

In recent years, FairPensions has led the debate on investors' fiduciary duties. Drawing on this work, Professor Kay has placed the concept of fiduciary duty, properly understood, at the heart of his vision for UK equity markets. But he also acknowledges that, improperly understood, it has too often been part of the problem.

In our 2011 report 'Protecting our Best Interests: Rediscovering Fiduciary Obligation', we argued that fiduciary duties are at present not fulfilling their intended purpose of ensuring that financial intermediation serves the interests of savers ahead of the interests of the City. We identified two key reasons for this, both of which are addressed in Kay's recommendations:

The 'what': clarifying the substance of fiduciary duties

- Mainstream interpretations of investors' fiduciary duties have been narrowed to a simplistic 'duty to maximise returns', which in turn is interpreted in terms of short-term performance relative to other investors or benchmarks.
- This exacerbates the focus on short-term share price movements and the neglect of factors which may affect a company's long-term value, such as environmental and social risks and opportunities.
- Kay concludes that, although the basic legal principles are sound, "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."

Kay's Recommendation: 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.

Further reading: FairPensions, 'The Enlightened Shareholder: Clarifying investors' fiduciary duties'.

The 'who': extending the scope of fiduciary duties

- Our assumptions about who holds fiduciary duties are outdated. Because fiduciary duties have their roots in UK trust law, it is often assumed that only trustees have fiduciary duties. So, for example, while trustees of occupational pension schemes have fiduciary duties, it is generally assumed that insurance companies providing personal pension schemes do not.
- This is an artefact of the UK legal system's distinction between trust and contract, rather than a conscious policy decision. It also no longer reflects the reality of who is making key investment decisions on behalf of the majority of savers, leaving significant gaps in the protections offered by fiduciary duties.
- Likewise, a 1992 Law Commission report concluded that asset managers and investment consultants have fiduciary duties, but this is not universally accepted or incorporated into FSA rules. Moreover, it is far from clear that these standards are applied in practice, particularly regarding the management of conflicts of interest.

Kay's Recommendation: Regulators should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions.

Further reading: FairPensions, 'Whose Duty? Ensuring effective stewardship in contract-based pensions'

FAIRPENSIONS' RESPONSE

Fiduciary duties

We strongly welcome Kay's focus on fiduciary duties and support the substance of both of his recommendations. However, we have concerns about the referral of recommendation 9 to the Law Commission.

- In our view such a referral is unnecessary. Professor Kay himself argues that "the common law provides clarity on what is meant by core fiduciary duties of loyalty and prudence", and that the need for clarification relates to the way these duties are applied by investors.
- It is not clear to us why the Law Commission is the appropriate body to give such clarification. It would be entirely legitimate and appropriate for the government to do so, particularly given the strong public interest in the behaviour of institutional investors.
- Nor is a referral justified by the complexity of the issues. FairPensions, in collaboration with experts in pensions law and company law, has produced draft legislation illustrating how statutory clarification could be achieved.
- The legal issues involved in this specific proposal are not excessively complex. If the government and regulators are competent to pronounce on who should have fiduciary duties – and Professor Kay suggests they are – then they are certainly competent to clarify what those duties mean.

In addition, it is vital to view the two recommendations as a package and to consider how they fit together. On this basis too, the referral of recommendation 9 to the Law Commission could jeopardise the success of the package.

- If fiduciary duties are to be extended to a wider range of actors, it is vital that all parties are clear about what is being extended: it would be perverse and counter-productive to extend the dysfunctional interpretation of fiduciary duty that prevails today.
- If anything, we would therefore suggest that clarifying the content of fiduciary duties is logically prior to extending them to a new set of actors. Referral to the Law Commission – a process which could take years - could therefore unnecessarily delay the implementation of both recommendations.
- It would be a mistake to conclude from this that the entire package should be referred to the Law Commission. The Law Commission has already considered the issue of scope[1] – indeed, its conclusions form the basis of Kay's recommendations on this subject[2] – and, as discussed above, asking it to consider the narrower issue of interpretation is simply unnecessary.

We therefore suggest that, if government is committed to implementing Kay's recommendations in a timely manner, it must pursue statutory clarification of investors' fiduciary duties as a matter of priority - ideally in the next parliamentary session.

Transparency and accountability

We agree that over-reliance on the assumption that markets are efficient has led regulators to wrongly assume that transparency is sufficient to achieve good outcomes. But we do not think it follows from this that transparency is not necessary or desirable.

Similarly, whilst we wholeheartedly agree with the application of fiduciary standards, we do not believe that these are a substitute for accountability and scrutiny. Fiduciary duties set out the standards of behaviour which intermediaries must meet, but scrutiny from both regulators and beneficiaries is needed to ensure that those standards are enforced.

The argument for greater transparency and accountability is not just economic but moral and political. The ultimate owners of capital – the millions of individuals saving into pensions, ISAs and the like – have a right to know what is happening to their money. Of course, they also have a right to forget about it and know that their interests will still be protected. But the active scrutiny of an engaged minority is one highly effective mechanism for ensuring that this is the case. Like all holders of delegated power, institutional investors should be accountable to those they represent.

At present, this is far from the case. Individual pension savers do not have the right to know where their money is invested or how shareholder rights are exercised on their behalf – and, in our experience, when they ask for such information they are often rebuffed. **In our view, enhanced transparency and accountability to ultimate owners is a vital and still largely unexplored agenda for change in capital markets.**

We therefore suggest that BIS should take forward this agenda as part of its work on responsible capitalism, following its implementation of binding shareholder votes on executive pay. As a starting point, government could exercise its reserve power to require institutional investors to publicly disclose their voting records.[3]

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ABOUT FAIRPENSIONS

FairPensions is a registered charity that promotes Responsible Investment (RI) by pension schemes and fund managers. RI generally involves shareholder engagement with companies to ensure that environmental, social and corporate governance (ESG) risks with the potential to affect long-term financial returns are monitored and managed. We also work with policymakers to improve transparency and accountability to savers, and to remove regulatory barriers to RI.

1. Law Commission, 1992, 'Consultation Paper No. 124: Fiduciary Duties and Regulatory Rules' (HMSO); Law Commission, 1995, 'Fiduciary Duties and Regulatory Rules', (HMSO)
2. See Kay Review Final Report, 2012, p65
3. See Companies Act 2006, section 1277