CFA SOCIETY OF THE UK

Kay Review: Final Report

Summary

The Kay Review of the UK Equity Market[1] made 17 recommendations (see Appendix) which it believes will enhance the ability of the UK equity market to support long-term corporate performance. The recommendations are based on the assumptions that companies will perform better if asset managers take a more active role in the stewardship of the companies in which they are invested and that the UK equity market suffers from short-termism. In doing so, companies will invest more, perform better and generate returns for savers.

While welcoming the review as making an important contribution to the debate around the role of the investment profession and the need for improved corporate governance, CFA UK was critical of the review's-

- lack of evidence supporting its assumptions
- exclusive focus on equity (rather than on all forms of capital); and
- the failure to recognise that the investment profession's primary responsibility is to deliver risk-adjusted returns for clients – not to manage the companies in which they invest.

CFA UK fully supports a number of the reviews' recommendations, believes others would benefit from slight modification and opposes several.

Kay Review Final Recommendations that we do not support:

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

The Stewardship Code[2] (Code) has been devised by the Financial Reporting Council (FRC) to enhance the quality of engagement between publicly listed companies and their shareholders. As the Code is not a rigid set of rules but implemented on a "comply or explain" basis; equity asset managers are provided flexibility in explaining how they undertake stewardship and provide the rationale for their approach.

CFA UK agrees without hesitation that asset managers are the stewards of the funds entrusted to them by investors and believes that asset managers should be concerned about corporate governance so that the companies in which they invest are properly managed. Asset Managers may choose to engage if they believe that it

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[1] Kay Review of Equity Markets Final Report
http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf

[2] CFA UK response to the Financial Reporting Council consultation on the Stewardship Code July 2012.
https://www.cfauk.org/assets/2572/CFA_UK_Response_FRC_Stewardship_Code_2012SENT.pdf

will add value to their clients, but asset managers' primary concern should not necessarily be with corporate decision-making. A concerned investor can make a principled, reasonable decision to sell rather than to engage. From an asset manager's perspective, it is stewardship over client assets that is key. That can be synonymous with the stewardship of corporate investments, but is not necessarily so.

An expansive definition should recognise the full spectrum of asset management approaches and consider mandates beyond equity. Savers are interested in the total return of their portfolios not just the equity allocation. It is our view the Stewardship Code, as it stands is not relevant to all asset managers.

We welcome the 'comply or explain' approach within the Stewardship Code. Enforced engagement where it is not appropriate to an investment strategy may be costly and ineffective. It is important that where engagement takes place it is of an appropriate quality to enhance long term shareholder value. Activist investors and others with material shareholdings in companies will have a greater incentive to engage than those with less material holdings.

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.

CFA UK agrees that senior executives' remuneration should be aligned to their ability to generate economic value[3]. However, the recommendation should be reworded to convey the principles supporting the structure of remuneration rather than the specific way in which remuneration is implemented. The ability to overcome the principal-agent problem through share based compensation is not demonstrated by the available evidence[4].

Remuneration based exclusively on equity has several weaknesses, including a susceptibility to gaming and the fact that it might lead management to focus on returns to equity holders when the company's capital may be more reliant on bank debt or bonds.

The issue of executive remuneration and incentivisation is complex. CFA UK intends to undertake research in this area and to develop guidelines for remuneration committees.

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.

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[3] CFA UK response to DBIS Consultation on Executive Remunerationhttps://www.cfauk.org/assets/2162/CFAUKresponse_to_executive_remunerationSENT.pdf
[4] CFA UK response to FRC consultation on the Code for Corporate Governance https://www.cfauk.org/assets/2572/CFA_UK_Response_FRC_CGovernance_Code_2012SENT.pdf

The aim of a remuneration structure should be to reward the investment professional who generates value by delivering the risk-adjusted returns that clients expect.

As we stated in our response to the Kay Review's call for evidence, the UK equity market enjoys a range of equity market asset managers that employ diverse investment strategies and are structured in a variety of ways (such as being publicly listed, partnerships or private companies).

Each firm should structure remuneration to reflect performance for the client over a period appropriate to the investment strategy. Some firms use performance fees while others encourage co-investment with clients. The remuneration structure will be related to the investment strategy and business model used by the asset manager

The review's recommendation, while conceptually pleasing may have limited applicability. In many asset management organisations individuals are not directly responsible for a single fund and in others they may not be responsible for a fund in which they could co-invest.

<u>Kay Review Recommendations that we broadly support:</u>

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.**

   We welcome any initiative that promotes and encourages higher professional standards. For company directors it is primarily a matter for the FRC[5] to address, although whatever controls are put in place; their aim should be to ensure company directors seek to generate economic value in a viable way.

   In the UK, investment professionals, including asset managers abide by the UK regulatory requirements which sets out the type of conduct expected of them. Those individuals who are members of the CFA UK additionally abide by the Code of Ethics and Standards of Professional Conduct. Both the UK regulations and the Code and Standards emphasise placing clients' interests first.

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

   We support this in principle, although the forum should include other providers of capital to publicly listed companies.

4. **The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by the Department for Business, Innovation and Skills (DBIS) and by companies themselves.**

   We believe that this is an important point which the review could have taken further. We believe that an assessment of the extent to which such activity has improved the ability of the companies involved to generate economic value would

[5] CFA UK response to FRC consultation on the Code for Corporate Governance
https://www.cfauk.org/assets/2572/CFA_UK_Response_FRC_CGovernance_Code_2012SENT.pdf

prove enlightening. Based on the evidence we have reviewed[6] we believe that shareholders have seen considerable value destruction through M&A activity.

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

Nominations Committees are responsible for proposing directors for shareholder approval. They may wish to consult existing shareholders, but should take care not to cause them to become 'shadow directors'. The recommendation also begs the questions: how will companies consistently and fairly identify 'major, long-term' investors and which appointments should be considered 'major' and which 'minor'?

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.

CFA UK members abide by the CFA Institute's Code of Ethics and Standards of Professional Conduct. The Code and Standards require CFA UK members to place their clients' interests first at all times and the duty of care should be of the same high standard irrespective of the sophistication of the client in question. UK regulatory requirements reflect this in that regulated firms and individuals must act in their clients' best interests.

CFA UK supports the maintenance of the highest levels of professional and ethical behaviour by all agents across the investment chain. The society advocates for high standards of stewardship in the care of client assets. However, we also note that a fiduciary responsibility is characterized by forbidding any conflict of interest to be experienced by an agent. Under fiduciary law, conflicts are not permitted, even if they are managed, mitigated and disclosed. We do not believe that it is realistic or practical to impose a fiduciary responsibility across the entirety of the investment chain, but strongly support the intention to require appropriate standards of stewardship, professionalism, duty of care and ethical behaviour.

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

CFA Institute's official position is that companies with securities listed on regulated markets should publish financial information quarterly. However, CFA Institute has spoken out against the practice of quarterly earnings guidance as a practice that does not contribute to effective investment decision-making as it inadequately accounts for the complex dynamics of companies and their long-term value drivers.

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

CFA UK responded in brief to DBIS' September 2011 consultation on the future of narrative reporting (and looks forward to responding to DBIS' October 2012 consultation on the subsequent draft legislation). In that response, we commented on the value of succinct reporting on issues that are material. We also noted that excellent guidance – that serves the needs of capital providers – is already available. We would always welcome and encourage useful narrative reporting, but

[6] CFA UK response to the Kay Review of UK Equity Markets, November 2011. https://www.cfauk.org/assets/2162/CFA_UK_response_to_the_UK_Equity_Market_Review_SENT.pdf

we hope that this recommendation is not taken as grounds for a further, unnecessary consultation on this topic.

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.

We agree with the review's statement that '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.' We also welcome the review's observation that the time horizon over which managers are judged should be sufficient to permit value discovery (or not) to be incorporated into that assessment.

We recommend that any review should limit itself to consideration of how to lengthen the performance horizon and reduce the value discovery horizon. Any review that is established might wish to look again at the findings of the Myners Report of March 2001.

With this in mind it may be useful for the Government to call upon the membership of CFA UK to assist in this review.

Recommendations that we fully support:

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

In the member survey that informed the society's original submission to the Kay Review, **63%** of respondents felt that the Board and senior executives of UK listed companies paid too much attention to short term share price movements and **86%** of respondents agreed (or strongly agreed) that the Board and senior executives of UK listed companies should focus on economic profits ahead of accounting profits.

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

The society's position on fees and charges is that fee structures and costs should be transparent and aligned with clients' interests. Clients and potential clients should know about the full range of types of fees and charges which will be applied against their assets.

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.

A clearer and broader understanding of the meaning and requirements of fiduciary duties and of distinction between those and the duties that investment professionals owe as stewards of those assets would be welcome.

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

This should obviously be so as the returns are derived from the clients' assets and are due to them.

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.

CFA UK agrees with this recommendation. We believe that this principle should be part of the broader regulatory philosophy applied to financial services. Executive remuneration[7] is a case in point where the focus has been on the quantum of pay rather than whether or not that level of remuneration has been objectively determined.

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

Enabling the development of low-cost, direct relationships between retail investors and the companies in which they invest is an attractive objective.

[7] CFA UK response to DBIS Consultation on Executive Remunerationhttps://www.cfauk.org/assets/2162/CFAUKresponse_to_executive_remunerationSENT.pdf

About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) is a member association for UK-based investment professionals adhering to a high standard of professionalism. CFA UK aims to serve society's best interests through the provision of education and training, the promotion of high professional and ethical standards and by informing policy-makers and the public about the investment profession.

The society supports the CFA Program® and is the awarding body for the Investment Management Certificate (IMC), the UK's leading entry level qualification for investment professionals.

Founded in 1955, CFA UK represents the interests of roughly 10,000 investment professionals. CFA UK is part of the worldwide network of member societies of CFA Institute (the global, not-for-profit association of investment professionals that awards the CFA and CIPM designations) and is the largest society outside North America.

The aim of CFA UK's advocacy initiative is to work with policy-makers, regulators and standard-setters to promote fair and efficient markets, high standards in financial reporting and ethical standards across the investment profession. The society is committed to providing members with information regarding proposed regulatory and accounting standards changes and bases its responses on feedback direct from members or relevant committees.

The Professional Standards and Market Practices Committee (PSMPC) of the Chartered Financial Analyst Society of the UK (CFA UK) has prepared this view of the recommendations in the Kay Review. CFA UK has not surveyed its members.

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Appendix

Kay Review Recommendations (CFA UK view in bold)

1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focusing on strategic issues as well as questions of corporate governance. **Not supported.**

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. **Broadly support**

3. An investors' forum should be established to facilitate collective engagement by investors in UK companies. **Broadly support**

4. The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by DBIS and by companies themselves. **Broadly support**

5. Companies should consult their major long-term investors over major board appointments. **Broadly support**

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

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. **Broadly supported.**

8. Asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund. **Support**

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. **Support**

10. All income from stock lending should be disclosed and rebated to investors. **Support**

11. Mandatory IMS (quarterly reporting) obligations should be removed. **Broadly support**

12. High quality, succinct narrative reporting should be strongly encouraged. **Broadly support**

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. **Broadly support**

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. **Support**

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. **Not supported.**

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. **Not supported.**

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