Chapter 2
The Kay Review of Equity Markets – game changer or missed opportunity?

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1. Introduction: background to the Kay Review

This chapter analyses the Kay Review of Equity Markets and Long-term Decision Making, which published its final report in July 2012. Although the Review focused on the UK, it nevertheless has significance for Europe as a whole. The Review has received significant attention outside the UK due to the quality of its analysis of the problem of short-termism in corporate governance, a problem which affects companies and investors beyond UK borders. The Review's analysis is largely supported by the British Trades Union Congress (TUC). However, the Review's recommendations, although quite detailed, focus largely on voluntary 'soft law' measures rather than the fundamental reform of corporate governance and the role of shareholders within it that the TUC believes is necessary.

In June 2011, the Right Honourable Vince Cable, then Secretary of State for Business, Innovation and Skills (BIS), asked economist and author Professor John Kay to carry out a review of the effect of equity markets on the competitiveness of UK business. The financial crisis that had peaked less than three years earlier had created a renewed interest in the role of shareholders in corporate governance. The recognition that shareholders had at best failed to curtail excessive risk taking on the part of financial institutions, or at worst had encouraged it, raised wider questions about the relationship between investors and the companies whose shares they own. These questions lay at the heart of the Kay Review.

The terms of reference of the Kay Review were to 'consider the ways in which the mechanisms of control and accountability provided by UK equity markets, and the behaviour of the agents in that process, affect the performance of UK businesses. The review will give particular emphasis to the ability of managers to focus on the actions needed to enhance the long term competitiveness of UK based firms and achieve the best long term returns for UK savers' (BIS 2011: 1).

A review of equity markets had particular significance in the UK context. Firstly, UK pension provision relies significantly on funded occupational pension schemes that have traditionally invested heavily in equities. So the performance of equity markets has a significant impact on the standard of living of retirees and the expectations of working people of their likely retirement income.

Secondly, shareholder engagement plays a vital role in the UK's system of corporate governance. Company directors are required under UK law to promote the success of the company for the benefit of shareholders. At the same time, shareholders have significant rights in relation to companies, including voting on all company resolutions, voting on remuneration reports and electing company directors each year at Annual General Meetings. It is also accepted that institutional shareholders, especially those with significant holdings, are able to meet with company management and non-executive directors on a regular basis to discuss ongoing issues or raise concerns. So, shareholders can have a significant impact on the priorities and strategic direction of company boards and therefore on company performance and workers.

John Kay's initial speech launching the review defined the core purposes of equity markets as being:

— to enhance the performance of UK companies; and
— to provide good returns to savers and pensioners through the activities of these businesses (Kay 2011).

A key strength of the Kay Review stems from this definition of what, fundamentally, equity markets are for. Too often other criteria such as liquidity are assumed to be a positive end in themselves, which can then be used to justify market characteristics that may, while increasing liquidity, not in fact contribute to long-term company performance or returns. The Review's clarity that everything other than enhancing the performance of UK companies and returns to savers is only important as a means to these two ends was a significant contribution to the debate.

2. Core findings of the Kay Review

The Kay Review's final report was published in July 2012. It concluded that equity markets have contributed to short-termism, or poor long-term decision-making, on the part of companies. Kay defines short-termism as a tendency to under-investment in physical assets or in intangibles, including employee skills, product development and reputation and a tendency to what he calls hyperactive activity on the part of executives – including restructuring, financial engineering, mergers and takeovers – at the expense of focussing on the operational fundamentals of the business. Evidence provided in the Review for the existence of short-termism includes relative R&D rates over time, data on mergers and acquisitions plus examples of poor long-term company decision-making that led to the destruction of company value (such as GEC and ICI).

An argument with particular significance in the UK, where shareholder engagement is ascribed a key role within the corporate governance system, is that the problem is not the amount of engagement with shareholders that takes place, but the quality of that engagement, and that equity markets encourage exit (the sale of shares) over voice as a means of engagement. Kay notes that in the examples of poor decision-making discussed in his report, many were strongly supported by shareholders. For the TUC, this is significant, as it supports our argument that there are fundamental flaws with the shareholder value model of corporate governance (see TUC 2013).

The Review assesses the main causes of the problems in equity markets as the following:

— Shareholding in UK companies has become increasingly fragmented. The proportion of shares held by large UK insurance companies and pension funds and individuals have all declined, while foreign shareholding has significantly increased.

— There has been an 'explosion' of intermediation in equity market investment. Kay ascribes this to a desire for 'professionalism' and a decline in trust in investment relationships. Intermediation, he argues, creates increased costs for investors, the potential for misaligned incentives and a tendency to view market effectiveness through the eyes of intermediaries, rather than from the perspective of companies or end investors. In the light of Kay's definition of the purpose of equity markets – to serve the interests of savers and companies – this has particular resonance.[1]

— Market commentators and regulators have been unduly influenced by the ‘efficient market hypothesis’, which Kay describes as ‘a poor basis for either regulation or investment’. This has led regulatory policy to focus on information disclosure as the response to conflicts of interests and/or imbalances of knowledge across the investment chain, which has not proved effective.

— The role of asset managers comes under particular scrutiny. Kay notes that they have become dominant in equity markets, both in terms of voting and engagement and stock selection. He distinguishes between an investment approach based on a view of a company’s fundamental value and a trading approach based on expectations of movements in the share price, and concludes that ‘current levels of trading activity exceed those necessary to support the core purposes of equity markets.’

— The incentives for active asset managers, based on short-term relative performance, encourage them to focus on the behaviour of other market participants, rather than the fundamentals of the businesses in which they invest. Kay notes that competition between asset managers on the basis of relative performance is essentially a zero-sum game; the asset management industry can only benefit savers as a whole if the industry as a whole is working effectively to boost company performance overall.

This analysis provides a very valuable account of the flaws of the current system and matches much of the TUC’s own analysis of the operation of equity markets over recent years. Such an analysis being put forward so clearly by a highly respected economist in a government-sponsored review has undoubtedly changed the terms of debate on the operation of equity markets and made it harder for insiders and/or vested interests to defend the status quo. This is helpful for all those who, like the TUC, argue for fundamental reform of equity markets and corporate governance.

1. On the issue of the ‘lengthening of the investment chain’ see the chapter by Habbard in this volume.

3. Kay Review recommendations

The Review set out a set of principles which it argues should guide practice and regulation and a number of recommendations (see Appendix to this chapter). Whether these are sufficient to address the problems the Review so cogently outlines is questionable, as will be discussed below.

The principles broadly concern the establishment of relationships based on trust, stewardship, fiduciary duty and a long-term perspective throughout the investment chain. All ten principles are easy to support and there is no doubt that, were they to be fully reflected in the behaviour of all participants in the investment chain, many, if not all, the problems described in the Review would cease to exist. However, the Review's own analysis makes clear that the problems within investment chains stem in the main from the structure of equity markets and the incentives of participants. It follows that successful reform will need to address these key areas, and that the principles presented by the Review should be seen as informing or as part of a wider set of reforms, rather than as necessarily being efficacious in their own right.

A key recommendation of the Review was that company directors, asset managers and asset holders should adopt Good Practice Statements to promote stewardship and long-term decision-making. Again, it is easy to support the contents of the three Good Practice Statements included in the Review; the problem lies in their being voluntary on the one hand and normative statements of behaviour on the other. As such, as with the Review's principles, it is not clear through what means these Statements on their own would have an impact.

The Review argues that through greater involvement investors could contribute more to the performance of British business, and, in consequence of this recommends that 'Asset managers should have greater incentives to engagement. Active asset managers should typically have more concentrated portfolios [and] [t]here should be more opportunity for collective action by asset managers' (Kay 2012: 50).

The TUC has long argued (along with others) that the very number of shareholdings held by asset managers makes it impractical for the latter to engage with all the companies whose shares they hold on all issues for which shareholders are ultimately responsible: there is simply not enough capacity within the organisations to carry out the work. Holding more concentrated portfolios would provide a solution to this. However, there is a great difference between asserting that this should happen and making it happen in practice. Just recommending that asset managers should hold more concentrated portfolios takes no heed of the reason why asset managers hold the shares of such large numbers of companies, which is precisely to diversify their risk. While other recommendations of the Review seek to encourage asset managers to take a different approach to risk (principle 8 says that risk should be seen as the failure of investments to deliver reasonable returns to savers and not in relation to tracking a benchmark), the approach behind holding such large numbers of shareholdings is so hard-wired into the industry that much more than wise words will be required to change it.

A significant and related recommendation was that an investors' forum should be established to facilitate collective engagement. This could address the inefficient use of resources created by investors carrying out many separate engagements and the disincentive to engage that is created by the fact that successful engagement produces gains for all investors equally, regardless of the resources each has put into the process.

To take this recommendation forwards, a Collective Engagement Working Group was established by the three main organisations representing institutional investors: the National Association of Pension Funds (NAPF), the Investment Managers' Association (IMA)[2] and the Association of British Insurers (ABI). Bizarrely, the Local Authority Pension Fund Forum, despite its established track record in carrying out engagement with companies on behalf of its 64 members, was not invited to participate in the group. In October 2014 the Investor Forum was quietly launched, publishing a discussion paper setting out its proposed approach. Its board includes John Kay and a range of asset owners and asset managers and, perhaps more surprisingly, one company Chairperson. The press release for its launch states that 'All long-term investors in UK companies, including international investors, are invited to join the Investor Forum' (Investor Forum 2012).

It is worth noting that the NAPF, the IMA (and its predecessor organisations) and the ABI had previously been key members of the Institutional Shareholders' Committee (ISC), producing a set of principles

2. In 2014 the IMA merged with the Investment Affairs Division of the ABI to create The Investment Association.

on 'The Responsibilities of Institutional Shareholders' in 1991 which were then updated over the years. This document formed the basis for the first draft of the UK Stewardship Code launched in 2010.[3] The ISC during its many years of existence neither promoted collective engagement effectively nor acted as a positive force for progressive reform of corporate governance. The IMA, representing the asset management industry, showed itself highly resistant to change, strongly opposing, for example, the TUC's campaign for mandatory fund manager voting disclosure.

The new Investor Forum includes a far wider range of representatives on its Board than were included within the ISC, including those from the pension funds Railpen and USS, which should improve its chances of becoming a more useful and progressive force than its predecessor. At the time of writing in Spring 2015, it is too early to say what the Investor Forum may bring about in terms of promoting collaborative engagement and changing the culture and practice of equity markets.

Perhaps the most potentially significant recommendation of the Review was that fiduciary standards should apply to relationships along the whole investment chain and should not be capable of being over-ridden by contracts. The Review argued that regulators at UK and EU level should review existing regulation and orchestrate a shift towards fiduciary standards in all relationships in the investment chain that involve discretion over the investments of others or investment advice. In addition, the Law Commission was asked to review the concept of fiduciary duty 'to address uncertainties and misunderstandings on the part of trustees and their advisers' (Kay 2012:13).

In theory, the application of fiduciary standards to relationships along the investment chain could solve many of the problems with the operation of equity markets. Fiduciary standards are incompatible with conflicts of interests (or at any rate, poorly managed conflicts of interests) and with decision-making that reflects the interests of the advisor or intermediary, rather than the end beneficiary. Opaque and unreasonable charges are also incompatible with the application of fiduciary standards. There is, however, a question as to whether applying fiduciary standards along the investment chain is compatible with the complexity that now characterises that chain. It is far from clear that every player in the

3. See Williamson (2012) for a TUC perspective on the Stewardship Code.

investment chain is equipped with the knowledge and understanding of the needs of end beneficiaries to be able to carry out a fiduciary duty to beneficiaries effectively. While the TUC would strongly support measures to reduce the complexity of that chain, it is not clear that applying fiduciary standards along the chain would necessarily have that effect. However, the aim of ensuring that the actions of every player in the investment chain serve the interests of end beneficiaries affected by their actions is one that the TUC would strongly support.

The Law Commission, as requested, carried out a review of fiduciary duty, producing a detailed consultation document and publishing its final report in July 2014. It did not recommend codifying fiduciary duty (as had been done with directors' duties in the 2006 Companies Act). It concluded that the Kay Review's recommendation that fiduciary standards should apply along the investment chain could not be achieved through reform of fiduciary duty, arguing that 'the principles set out in the Kay Review are so far removed from the courts' interpretation of fiduciary duties that we do not think that it is possible to create the first from the second' (Law Commission 2014: 207).

It did, however, set out its view on the relationship between fiduciary duty and consideration of social, environmental and ethical standards, arguing that all factors affecting long-term financial performance, including environmental, social and ethical issues, should be considered, but that it was up to fiduciaries such as pension fund trustees to evaluate which risks are material and how to take them into account. In addition, the Law Commission argued that trustees could take account of non-financial factors if they had good reason to think that scheme members would share their concern and the decision did not involve a significant risk of financial detriment to the fund.

At the time of writing, the Department for Work and Pensions was in the process of consulting over amending the regulations governing trustees' duties to reflect the Law Commission's conclusions. The Pensions Regulator has updated its guidance to reflect the Law Commission's report, with more amendments planned over the year ahead. In addition, the government has requested that the Financial Conduct Authority consider to what extent current regulation aligns with the principle of fiduciary duty (though how practical it would be to amend detailed rules to reflect the broad principle of fiduciary duty to end beneficiaries remains to be seen).

The clarification by the Law Commission that trustees should take account of social, environmental and ethical factors where they are or may be financially material is helpful in clarifying an issue that has been the subject of considerable misunderstanding since the case of Cowan vs Scargill in 1985. Useful work had already been done by Freshfields (2005) and the United Nations Environment Programme (UNEP 2009) on the subject, but the Law Commission's role as a statutory body lends weight to its conclusions, and it is positive that the latter have received good publicity in the investment world. The issue of extending fiduciary duty along the investment chain, on the other hand, seems to have fallen into the long grass (unless the Financial Conduct Authority should come up with amendments to its rules to reflect this aim).

Another important recommendation of the Kay Review was that asset managers should make full disclosure of all costs, including transaction costs. This is something for which the TUC has advocated strongly. Lack of transparency on the extent of charges and the basis on which they are applied is a major cause of conflicts of interest along the investment chain, and addressing this is a prerequisite for ensuring that equity markets serve the interests of end beneficiaries, rather than market participants.

It is particularly welcome that the Review stipulated that, in addition to other costs, transaction costs should be disclosed. Clarity about the direct costs of trading in shares should help to expose the extent to which fund managers are pursuing strategies based on share trading, as opposed to long-term shareholding, even for clients like pension funds that are investing over a very long timeframe. Information about transaction costs is also a necessary ingredient for an assessment of the effectiveness or otherwise of this approach.

Since the Kay Review, the UK government has introduced requirements for providers of workplace pension schemes to report annually on value for money within the scheme, including administrative charges and transaction costs. The main spur for this was a highly critical study of the market in defined contribution pension schemes carried out by the Office of Fair Trading in the context of mandatory automatic enrolment into pension schemes (OFT 2013). Greater transparency regarding administrative and transaction costs should help to address the conflicts of interest identified in the Review.

As noted above, Kay argued that the incentives for active asset managers, based on short-term relative performance, contribute to short-termism in equity markets. To address this, the Review recommended that asset management firms should design remuneration to align the interests of individual asset managers with the interests and timescales of their clients. It specifically recommended that a long-term performance incentive in the form of an interest in the fund should be held by the fund manager for the duration of responsibility for that fund.

While agreeing that asset managers' remuneration should not depend on short-term fund performance, the TUC is far from convinced that trying to create incentives that link the financial interests of asset managers and clients will work. The TUC is sceptical about the effectiveness of performance-related pay. Research has shown performance-related pay to be ineffective in terms of boosting motivation for complex tasks (Ariely 2010). There is also a question as to whether using financial incentives sends the right signal to asset managers in terms of the underlying purpose of their role – to serve the needs of other people for financial security in the future – and the types of behaviours required to deliver this. The Review argues forcefully that there is a need to move towards relationships based on trust, rather than contractual complexity, along the investment train. However, the use of financial incentives to mould behaviour assumes that a desire to make money, rather than to safeguard beneficiary interests in their own right, is the way to motivate and direct asset managers, which is surely not the best way to generate relationships based on trust. There is also the difficulty of designing remuneration packages that align the interests and timescales of asset managers with end beneficiaries - given the very long timescales of pension funds beneficiaries, it is far from clear how this could be done. The experience of designing performance targets for executive remuneration is not promising in this regard.

The TUC would support a move away from performance-related pay for both asset managers and company directors and believes that much simpler remuneration packages with greater reliance on basic salary would reduce the scope for conflicts of interest, boost transparency and help to stop the inexorable increase in the gap between the pay of company directors and asset managers and that of ordinary workers. Nonetheless, the Review's recommendation in this area would be an improvement on the status quo. However, no detail is given on how it should be implemented or monitored and it is not clear that it has had any impact on practice to date.

The recommendation that received most attention when the Review was published was that mandatory quarterly reporting should be abolished, perhaps because this was the only one that required an explicit change in the law. The TUC supports this reform, although to the extent that reliance on quarterly reporting may be a symptom of short-termism as much as a cause, it will be interesting to see how much impact it has on short-termist behaviour. The UK's Financial Conduct Authority removed the requirement for listed companies to publish quarterly reports (or interim management statements) in November 2014, following changes to the EU Transparency Directive. Since then, a few large companies have announced that they are no longer going to produce first and third quarter reports, including National Grid, United Utilities, Diageo and G4S. National Grid's Finance Director commented that the change could save up to a month of senior management time a year (FT 2015a).

Some asset managers and the Financial Reporting Council have publicly supported companies that have ended quarterly reporting and Legal & General Investment Managers, one of the UK's largest fund managers, recently wrote to all FTSE 350 companies arguing that providing quarterly updates offers little value for companies operating in long-term business cycles (FT 2015b). However, the market reaction in terms of share price suggests that not all investors are convinced: National Grid's shares fell nearly 1 per cent after the company's announcement of ending quarterly reporting, while FTSE 250 coal producer New World Resources saw its shares drop 22 per cent when it said in 2013 that it would replace regular guidance with 'timely' updates. But this has not prevented other companies from following their example and it seems probable that not issuing quarterly reports will become both increasingly common among companies and increasingly accepted by investors.

Mergers and takeovers could be seen as the dog that didn't bark in the Kay Review. The Review is very critical of the effect of mergers and takeovers on company performance and merger and takeover activity is included as an example of the 'hyperactivity' on the part of company managers that characterises short-termism. Mergers and acquisitions contributed to some of the examples of company failure included in the Review. The Review argues that the market for corporate control does not 'ensure that the management of corporations is always placed in the most capable hands', and that the UK cannot 'be wholly indifferent to the location of corporate headquarters'. It also argues that the limitation of the grounds for intervention in mergers and takeovers to competition grounds (brought in by the Enterprise Act of 2002) ‘has not necessarily been beneficial’ (Kay 2012: 58-59).

Despite this position, the Review’s one recommendation to address this is that ‘[t]he scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves’ (Kay 2012:62). It argues that the government should make use of its formal and informal authority to influence potential takeovers. However, its main argument is that the development of stewardship activities and a move away from a trading culture would be the most effective remedies to the current situation.

Given the link between the way mergers and takeovers operate in the UK and short-termism, it is disappointing that the Review does not give more attention to this area and it is hard to see its one recommendation as an adequate response to the situation it describes. There is little discussion of other proposals for reform of mergers and takeovers, nor of how the regimes in other countries operate. The argument that the development of stewardship activities would provide the best solution on this places great faith in stewardship leading to a different approach to company performance on the part of both investors and company management. It also relies on the other proposals in the Review succeeding in boosting stewardship to the extent that additional reform of mergers and takeovers is unnecessary.

The TUC believes that reform of the UK mergers and takeovers regime is both necessary and urgent, and calls for the establishment of a body that would operate at arm’s length from government and to whom potential mergers could be referred on grounds of long-term company impact, rather than just competition as at present.[4]

There are, however, some interesting points of comparison between the two highest profile takeover bids for UK companies in recent years – Kraft’s hostile takeover of Cadbury in 2010 and Pfizer’s attempted takeover of AstraZeneca in 2014. In 2011, largely as a response to the Kraft-Cadbury takeover, the UK’s Takeover Code was amended to make clear that company directors are not required to recommend a bid to shareholders on the basis of a high offer price if they do not believe the bid is in the long-term interests of the company. The Kay Review briefly

4. For more information on the TUC’s proposals on mergers and takeovers see TUC (2010).

noted that directors' legal duties to promote the long-term success of the company for the benefit of its members addressed the issue of whether directors can legally recommend that a high bid be rejected. In its response to the Kay Review, the government supported this conclusion and referred to the Takeover Code amendment on that point.

The response of the AstraZeneca board to Pfizer's hostile bid was notably different from that of the Cadbury board during the Kraft bid. The Cadbury board's main argument against the takeover was that the share price offered was too low and did not fully reflect the company's true value. Consistent with this approach, when Kraft finally raised the offer price, the board recommended that shareholders accept the bid. The AstraZeneca board, on the other hand, did not put the offer price at the centre of their defence, arguing instead that AstraZeneca would be more successful as an independent company and that the Pfizer bid would lead to reductions in R&D, skills and the company's drug development programme. Taking the debate away from the share price was crucial for the ultimate success of the board's defence; if all they had talked about was the offer price and Pfizer had then raised that offer price, they would have had little option but to recommend the bid. As it was, AstraZeneca today remains an independent company which continues to invest in high-skilled R&D work in the UK.

Not all takeover bids concern companies as research and skills intensive or as high profile as AstraZeneca and, as already noted, the TUC continues to believe that reform of mergers and takeovers is necessary. Nonetheless, the contrast between these two bids suggests that the relatively subtle reform of the Takeover Code in 2012 has made a genuine impact on practice, at least in this case.

4. Conclusion

The Kay Review's analysis is excellent. It sets out what the core purposes of equity markets should be; describes clearly the complexity and conflicts of interest that hamper the investment chain; and makes a compelling argument that dysfunctionalities within capital markets are damaging both savers and the real economy.

However, the TUC believes that the Review's recommendations are not sufficiently strong to address the extent of the problems it so clearly outlines. Too much faith is placed in what are essentially voluntary measures, while few concrete mandatory measures are proposed by the Review. The TUC's experience over the last decade of campaigning for asset managers to disclose their voting records shows that much of the industry is very reluctant to change its behaviour unless forced to do so.

The Review argues that the problem with the interaction between shareholders and companies is damaging company performance in the UK, which chimes absolutely with the TUC's own analysis.[5] However, the TUC concludes from this that fundamental reform of the UK's corporate governance system, and the reliance on shareholder engagement within it, is necessary and urgent. We would like to see directors' duties re-written so that directors are required to promote the long-term success of the company as their primary duty, with the promotion of shareholder interests secondary to this central aim. The TUC has also called for the introduction of stakeholder participation in corporate governance and for the representation of workers on company boards. In other words, we would like to reform the role of shareholders within the UK's corporate governance system and remove the priority given to their interests. While these proposals go beyond the scope of the Kay Review and were never on its agenda, there is nonetheless a gap between the stark picture painted by the Review and the recommendations it proposes. The TUC remains sceptical about whether the Review's proposed reforms will be sufficient to overcome the difficulties caused by the fragmentation of shareholdings, excessive intermediation and a reliance on trading strategies it so eloquently sets out.

Take, for example, the barriers to engagement created by the highly diversified holdings of most asset managers. The Review clearly sets out the problem; to address it, it includes a direction to asset managers: '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'. The problem is that simply stating what should happen is by no means sufficient to bring this change about. Unless the 'need' of asset managers to hold diversified portfolios to protect themselves against risk is addressed, they will continue to hold large portfolios.

5. See e.g. Williamson (2012) and TUC (2013).

A gap in the Kay Review is the role of asset owners, about whom there is relatively little discussion. This is disappointing, as some investigation of how requirements for pension scheme funding may contribute to short-termism in equity markets would have been useful. Defined-benefit pension schemes in the UK are required to carry out valuations every three years based on mark-to-market accounting and to set out plans to address any deficits. This means that trustees have to focus on value creation over relatively short timescales, which may sometimes take their attention away from long-term performance. The TUC raised this in its submission to the Kay Review (TUC 2011). It is a difficult area to address, as clearly funding requirements for pension schemes exist for very good reasons; but it is disappointing that these issues were not picked up by the Review. Another issue that would have benefited from inclusion in the Review is the tax relief on interest payments on corporate debt. There is increasing recognition that this has distorted markets by encouraging investment to take the form of debt rather than equity and there have been widespread calls for its abolition. Despite this, the issue was not covered in the Review.

To conclude, the strength of the Kay Review is undoubtedly its analysis - the accurate description of the practice of equity markets and correctly ascribing this to the incentives and structure of the market. This has had a lasting impact on the terms of debate around equity markets and short-termism in the UK. The Review's weakness is its recommendations, which rely too much on normative statements and voluntary measures to address sufficiently the problems it sets out. But perhaps we need to make judgement over the longer-term; it is not possible to redesign equity markets overnight and the Review may have an impact in the medium or long-term through influencing the direction of future regulation and incentives. But there is also a danger that it slips too easily beneath the water, leaving ripples that still too quickly to disturb the supertanker of dysfunctionality it was designed to overturn.

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Appendix: Kay Review Principles and Recommendations

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.

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 take 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.

Source: Kay (2012)