The Kay Review: Implications for Pension Funds

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The Kay Review of UK Equity Markets and Long-Term Decision Making

Final Report

July 2012

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Kay Review – the Statistics

112 Pages

10 Principles

17 Recommendations

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Kay Review Recommendations

1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.
2. Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should 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.

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Kay Review Recommendations (2)

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 judgement.
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.

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3 Statements of Good Practice

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3 Statements of Good Practice

For “Asset Holders”

For Asset Managers

For Company Directors

Not “more Codes”, more descriptions of desirable behaviours, to be discussed and developed…and adopted.

Overarching aim – to restore **trust** to all elements of the investment chain.

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Principle

Asset managers can contribute more to the performance of British business (and in consequence to overall returns to their savers) through greater involvement with the companies in which they invest

Strengthening the investment chain

Direction - Asset managers should have greater incentives to engagement.

Active asset managers should typically have more concentrated portfolios which are more differentiated from each other and from benchmark indices.

Regulatory discouragements to such behaviour should be removed;

There should be more opportunity for collective action by asset managers;

The fear of regulatory consequences should be removed;

Passive managers should engage to improve index performance.

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Good Practice Statement for Asset Holders

Asset Holders should…

1.recognise that they are in a position of trust managing client money and should act at all times in the best long-term interests of their clients, informing them of possible conflicts of interest and avoiding these wherever possible.

2.operate within a culture of open dialogue with beneficiaries – building an agreed understanding of investment objectives and risks.

3.provide information on beneficiaries, including information on investment performance, in a way which is clear, timely, useable and relevant to clients' investment objectives.

4.be proactive in setting mandates for asset managers based on open dialogue about agreed investment objectives

5.set mandates which focus managers on achieving absolute returns in line with beneficiaries long-term investment objectives, rather than short-term relative performance benchmarks.

6.recognise that diversification is the result of diversity of investment styles.

7.review performance no more frequently than is necessary, and with reference to long-term absolute performance.

8.encourage and empower asset managers to engage with investee companies as a means of improving company performance to deliver investment returns.

Good Practice…?

2. operate within a culture of open dialogue with beneficiaries – building an agreed understanding of investment objectives and risks.

3. provide information on beneficiaries, including information on investment performance, in a way which is clear, timely, useable and relevant to clients' investment objectives.

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(Really) good practice

5. set mandates which focus managers on achieving absolute returns in line with beneficiaries long-term investment objectives, rather than short-term relative performance benchmarks.

7. review performance no more frequently than is necessary, and with reference to long-term absolute performance.

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Asset Managers should….

7. prioritise medium to long-term value creation and absolute returns rather than short-term returns from market movements when making investment decisions

8. build an ongoing relationship of stewardship with the companies in which they invest to help improve long-term performance – recognising that engagement goes beyond merely voting.

9. make investment decisions based in judgments about long-term company performance, informed by an understanding of company strategy and a range of information relevant to the specific company, and avoiding reliance on single measures of performance.

10. be prepared to act collectively to improve the performance of their investee companies

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Asset managers should be paid….

11…. in line with the interests and timescales of their clients. Specifically remuneration should not be related to short term performance of the investment fund or the performance of the asset management firm. Instead, a long–term performance incentive should be provided in the form of an interest in the fund (directly or via the firm) to be held until the manager is no longer responsible for that fund.

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Company Directors should….

2.acknowledge that long-term value creation in the interests of shareholders is best served by strategies which focus on investing appropriately to deliver sustainable performance rather than treating the business as a portfolio of financial interests.

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Company directors should also…

8. not allow expectations of market reaction to particular short-term performance metrics to significantly influence company strategy.

10. be paid in a way which incentivises sustainable long-term business performance: long-term performance incentives should be provided in the form of company shares to be held until after the executive has retired from the business.

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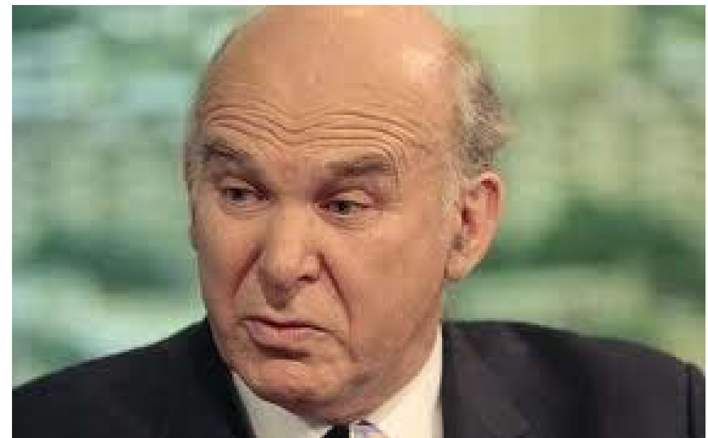
Next Steps

Rt Hon Dr Vince Cable to announce his response "in the Autumn".

Pension funds can refine and adopt "good practice" anyway.

And encourage fund managers and Company Directors to do so.



It's in our members' interest.

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Principles, Recommendations & Statements of Good Practice

Kay Review Principles

1. All participants in the equity investment chain should act according to the principles of stewardship, based on respect for those whose funds are invested or managed, and trust in those by whom the funds are invested or managed.
2. Relationships based on trust and respect are everywhere more effective than trading transactions between anonymous agents in promoting high performance of companies and securing good returns to savers taken as a whole.
3. Asset managers can contribute more to the performance of British business (and in consequence to overall returns to their savers) through greater involvement with the companies in which they invest.
4. Directors are stewards of the assets and operations of their business. The duties of company directors are to the company, not its share price, and companies should aim to develop relationships with investors, rather than with 'the market'.
5. All participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers. Fiduciary standards require that the client's interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed. These standards should not require, nor even permit, the agent to depart from generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards.
6. At each stage of the equity investment chain, reporting of performance should be clear, relevant, timely, related closely to the needs of users and directed to the creation of long-term value in the companies in which savers' funds are invested.
7. Metrics and models used in the equity investment chain should give information directly relevant to the creation of long –term value in companies and good risk adjusted long-term returns to savers.
8. Risk in the equity investment chain is the failure of companies to meet the reasonable expectations of their stakeholders or the failure of investments to meet the reasonable expectations of savers. Risk is not short-term volatility of return, or tracking error relative to an index benchmark, and the use of measures and models which rely 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.

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Kay Review Recommendations

1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.
2. Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should 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.
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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.

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Kay Review Recommendations (2)

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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 judgement.
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.

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Good Practice Statement for Asset Managers

Asset Managers should…

1.recognise that they are in a position of trust managing client money and should act at all times in the best long-term interests of their clients, informing them of possible conflicts of interest and avoiding these wherever possible.

2.operate within a culture of open dialogue with their clients – building an agreed understanding of investment objectives and risks, which is informed by their investment expertise.

3.provide information to clients, including information on investment performance, in a way which is clear, timely, useable and relevant to the tong-term creation of value in the investee companies, and therefore to clients' investment objectives.

4.disclose fully all costs that fall on investors in a way that investors can understand.

5.ensure that income generated from lending securities is rebated in full to the fund, with any related costs disclosed separately.

6.Adhere to the investment strategy agreed with clients.

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Good Practice Statement for Asset Managers (2)

Asset Managers should…

7.prioritise medium to long-term value creation and absolute returns rather than short-term returns from market movements when making investment decisions

8.build an ongoing relationship of stewardship with the companies in which they invest to help improve long-term performance – recognising that engagement goes beyond merely voting.

9.make investment decisions based in judgments about long-term company performance, informed by an understanding of company strategy and a range of information relevant to the specific company, and avoiding reliance on single measures of performance.

10.be prepared to act collectively to improve the performance of their investee companies

11.be paid in line with the interests and timescales of their clients. Specifically remuneration should not be related to short term performance of the investment fund or the performance of the asset management firm. Instead, a long–term performance incentive should be provided in the form of an interest in the fund (directly or via the firm) to be held until the manager is no longer responsible for that fund.

Good Practice Statement for Company Directors

Company Directors should…

1.understand their duties as directors under the Companies Act 2006, and in particular acknowledge the relevance of considering long-term factors, including relevant environmental, social and governance issues, and the reputation of the company for high standards of business conduct, in fulfilling their duty to promote the success of the company.

2.acknowledge that long-term value creation in the interests of shareholders is best served by strategies which focus on investing appropriately to deliver sustainable performance rather than treating the business as a portfolio of financial interests.

3.act to ensure that the intermediation costs associated with a publicly traded company are kept to a minimum.

4. ensure that corporate reporting is focused on forward looking strategy.

5.facilitate engagement with shareholders, and in particular institutional shareholders such as asset managers and asset holders, based on open and ongoing dialogue about their long-term concerns and investment objectives.

6.provide information, in the context of corporate reporting and ongoing shareholder engagement, which supports shareholders' understanding of company strategy and likely long-term creation of value, including by agreeing a range of performance metrics relevant to the company.

7.communicate information to shareholders which aids understanding of the future prospects of the company, even if this means going beyond (but not against) the strict requirements of accounting standards, for example on market valuations

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Good practice Statement for Company Directors (2)

8.not allow expectations of market reaction to particular short-term performance metrics to significantly influence company strategy.

9.refrain from publishing or highlighting inappropriate metrics which may give a misleading impression of anticipated future company performance.

10.be paid in a way which incentivises sustainable long-term business performance: long-term performance incentives should be provided in the form of company shares to be held until after the executive has retired from the business.

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