



House of Commons

Business, Innovation and Skills
Committee

**The Kay Review of UK
Equity Markets and
Long-term Decision
Making: Government
Response to the
Committee's Third
Report of Session
2013–14**

**Second Special Report of Session
2013–14**

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Business, Innovation and Skills Committee

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The Reports of the Committee, the formal minutes relating to that report, oral evidence taken and some or all written evidence are available in a printed volume. Additional written evidence may be published on the internet only.

Committee staff

The current staff of the Committee are James Davies (Clerk), Amelia Aspden (Second Clerk), Peter Stam (Committee Specialist), Josephine Willows (Committee Specialist), Ian Hook (Senior Committee Assistant), Pam Morris (Committee Assistant), Henry Ayi-Hyde (Committee Support Assistant).

Contacts

All correspondence should be addressed to the Clerk of the Business, Innovation and Skills Committee, House of Commons, 14 Tothill Street, London SW1H 9NB. The telephone number for general enquiries is 020 7219 5777; the Committee's email address is biscom@parliament.uk

Second Special Report

The Committee published its Third Report of Session 2013–14, *The Kay Review of UK Equity Markets and Long-term Decision Making*, on 25 July 2013. The Government's Response was received on 10 October 2013 and is appended to this Report.

The Committee's original recommendations are reproduced in boxes throughout the Government Response.

Appendix: Government Response

Introduction

1. The Kay Review set out a radical agenda to address misaligned incentives and to restore relationships of trust and confidence in the investment chain. Its goal was to shift the culture of equity markets to promote a longer-term outlook in UK equity markets and enable UK companies to deliver sustainable economic growth. The Government believes that a sustained commitment to reform, from both government and market participants, will be necessary to achieve this agenda. The Government therefore welcomes the Committee's inquiry into the Kay Review as a helpful contribution to this objective.
2. The Committee Report makes a number of recommendations concerning the Government's approach to implementing the Kay review (see Box 1 overleaf). The Government agrees that it must play an active role in ensuring continued progress to delivers this agenda. We therefore welcome the opportunity to set out a summary of key areas of action, progress achieved to date, and clear objectives for further progress to be achieved before summer 2014, when the Government has committed to publishing a more detailed progress report. This is set out in **Annex A** below. The Government's 2014 progress update will report on these objectives and also include a wider evaluation of relevant economic and behavioural outcomes.
3. The Government has not ruled out legislative or regulatory measures where there is a clear case that they will be effective in bringing about the changes advocated by the Kay Review. This is why in certain areas we have pursued legislative changes, for example to remove mandatory quarterly reporting. We note, and agree with, Professor Kay's view that additional prescriptive regulation of behaviour is unlikely to achieve the cultural change which is needed. Much of the change must be made by the investment industry itself.
4. In addition to a number of specific Government policy measures, and areas of further policy analysis, the Government is therefore focused on promoting Professor Kay's principles and vision of good practice in the investment chain, as the basis for the development of good practice among market participants. We are also working with the regulators in a number of areas to explore further the review's implications for regulatory policy, notably to identify whether there are unintended and undesired

consequences from existing regulation and whether changes to better align regulations with the Kay principles may be appropriate.

5. The Government has been encouraged by the willingness to develop good practice initiatives in response to the Kay Review, from both business and the investment community. Despite these positive efforts, we recognise that much remains to be done. The Government remains determined to take forward the Kay Review agenda, in order better to ensure long-term and sustainable economic growth. As noted above, we will report back on progress made, lessons learnt and objectives for the future in summer 2014.

Box 1: Recommendations concerning the Government’s approach:

Previous review of the market

In the 12 years since the Myners Review, little has changed in the role and actions of institutional shareholders. The recommendations and findings of the Kay Review cannot be ignored or diluted as we have heard the Myners Review was. The similarities between the remit of the Kay review and that of the Myners Review demonstrate that little progress has been made to reform the sector. It is therefore critical that they do not share a similar fate. The Government must play an active role to drive reform on implementation of Professor Kay’s recommendations. Our Report, therefore, concentrates on where that activity must take place. **(Paragraph 14)**

Measuring success

Lord Myners’ Review was published more than a decade ago and yet we find ourselves examining the same issues and principles in the Kay Review today. Professor Kay’s findings and proposals must not be ‘kicked into the long grass’ by the Government or the industry. Professor Kay’s specific recommendations need to be acted on and we will hold those responsible to account. Where Professor Kay has provided overarching principles these need to be turned into actions. The Secretary of State has assured us that there is an appetite for change in the Government and we have heard that this is mirrored in the industry. Therefore, there can be no excuse for inaction by either the Government or the industry.

We recommend that the Government immediately publishes clear, measurable and achievable targets for implementation of the Kay Review. In particular, in its response to this Report, the Government must outline for each of Professor Kay’s 17 recommendations what needs to have been achieved by the Government’s review of progress in 2014. **(Paragraphs 134-135)**

Regulatory or voluntary approach

We sympathise with Professor Kay and the Secretary of State’s concerns that overprescription and formal legislation risk alienating the UK equity market in a global environment, providing false security through ‘tick-boxing’ and distorting the effective operation of the market. However, we have yet to be convinced that all of the major players in the institutional investment sector are committed to significant voluntary reform.

We agree that the industry should be given a chance to change of its own volition but the experience of the Myners Review does not fill us with confidence. A cultural change will not happen without a catalyst. Ministers must be willing, and seen to be willing, to pick up a ‘regulatory stick’ should progress stall. We reiterate our recommendations that the Government has to set out a timetable for reform which includes the following for every one of Professor Kay’s recommendations:

- a clear measure of success for the recommendation (the target);
- who is responsible for achieving the target;
- a clear deadline by which the target needs to be achieved; and
- the action that the Government will take if the target is not achieved.

(Paragraphs 144-145)

Government responses to specific policy recommendations:

6. The Committee’s report also made a variety of specific policy recommendations for the Government to consider—relating to the recommendations in Professor Kay’s final report. The Government’s response to each of these recommendations is set out below.

Investors Forum / Collective Engagement

We agree with Professor Kay and the Government that collective engagement is to the benefit of the equity market and UK businesses. However, we are concerned that the hands-off approach taken by the Government runs the risk that progress will stall. The Government has provided no remit, deadline or resource for the Investor’s Forum and the ‘working group’ to investigate the concept of the Investor’s Forum will not report until later in 2013. The Government has told us that it will publish an update on progress in the summer of 2014. We recommend that the Government outlines a clear timetable for setting up the Forum before that point, engaging with different types of investors, along with milestones and assigned responsibilities for achieving this. **(Paragraph 27)**

7. The Government fully supports the Committee’s view that it should play an active role in encouraging the establishment of an “Investors’ Forum” and in promoting effective collective engagement by a broad range of investors. For this reason BIS officials are in regular contact with a range of stakeholders across the investment industry, with progress on this recommendation a frequent focus of discussions.
8. We also believe that investors rather than the Government should establish the forum and define how it works in detail. Were government to do so then it would be less likely to attract the support of the investment community. Instead, investors themselves need to take responsibility for developing a forum which works for them.
9. We therefore welcome the establishment of an independent Working Group on collective engagement, representing a range of perspectives within the investment

industry, and championed by the Investment Management Association (IMA), the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF). We look forward to its report in November 2013. We will respond quickly to any issues for Government identified in the Working Group report, and expect the industry to also act quickly and positively to take forward its recommendations.

10. We accept that there are challenges involved in designing a forum which will attract the critical mass of investors necessary for it to be effective. We are therefore optimistic that the growing support for the Working Group will form the basis for the creation of an effective structure for improving collective engagement by the end of 2013. If no such structure emerges following the report of the Working Group this November, the Government will convene a conference of senior representatives from major UK institutional investors, early in 2014, to identify and resolve any outstanding barriers to progress in this area.
11. Two other developments are also worth noting in this context:
 - The ABI, whose members are represented on the working group, has committed to expanding its existing collective engagement process to include all significant shareholders—whether or not they are ABI members. It is also setting up an “investor exchange” mechanism, to enable any significant shareholder to raise a concern on a particular UK listed company with other shareholders. The Government welcomes these developments.
 - The NAPF has also consulted on the development of a “Stewardship Framework” against which asset managers will be encouraged to self certify, indicating to pension funds and other clients the extent to which they fulfil a number of different categories of good practice in stewardship. The framework invites asset managers to indicate, among other things, the extent to which they undertake collective engagement. We welcome this initiative as a helpful means for asset holders to signal their appetite for stewardship activity from their asset managers, and in particular hope that it will sharpen the commercial incentives on asset managers to engage collectively with companies.
12. As the Government Response to the Kay Review made clear, we will soon be commissioning a small group of respected senior figures from business and the investment industry to assess industry progress on shareholder engagement, both collectively and individually. Their views will complement the Government's own Kay Progress Report due in summer 2014.

Fiduciary duty

The Law Commission is currently consulting on the legal definition of fiduciary duty and will not report back until June 2014. We believe that this is too slow. We recommend that the Government liaises with the Law Commission to bring forward the timing of this project. The Government is paying up to £140,000 for this project and we expect it to push for the highest value for the taxpayer's money. The Law Commission will launch a three month consultation in October 2013. We suggest that it gives this issue the appropriate priority and publishes its final definition in the first quarter of 2014. **(Paragraph 36)**

13. The Government notes that the Law Commission has written to the Committee in response to this recommendation. We support the position set out in that letter, which makes clear that the Law Commission's will consult by October 2013 and publish its report by June 2014.
14. The Government consulted with a variety of stakeholders on the scope and agreed timetable for the review and believe they enjoy widespread stakeholder support.
15. We have had regular meetings with Law Commission officials to ensure that the project is progressing on track. The expected total cost of the project is now £125,000, which we hope demonstrates that both the Government and the Law Commission are focused on value for money.

Appointment of executives

Professor Kay has provided a clear recommendation, proposing that companies consult with major investors over all board appointments and the Government has agreed to implement this. We therefore recommend that the Government publishes a timetable for the implementation of this policy, clarifies which investors companies are to consult with and outlines how it intends to combat the issues surrounding insider trading and confidentiality which inevitably accompany such board appointments. Alongside this, the Government should undertake an impact assessment, particularly looking at the possible increase of bureaucratic burdens on small businesses and, if necessary, introduce an opt-out clause for them. **(Paragraph 43)**

16. The Government's Response to the Professor Kay's recommendation set out our view that effective consultation of shareholders on major board appointments was a matter on which companies should be encouraged to develop good practice. The Government consequently does not plan to regulate the specific approach taken by companies in this area. Rather we would like to see companies agree appropriate and effective approaches to consult on board appointments according to the needs of their investors.
17. In addition, the Government notes that existing provisions of the Corporate Governance Code (relating to the effectiveness of companies' boards and their relations with shareholders) are consistent with the practice of companies consulting on board appointments. The FRC is currently looking at the work of nomination committees, including the board appointment process, and will report its findings in its annual report on corporate governance and stewardship, expected in December. If the FRC concludes that changes to the Code are needed, consultation will begin in the first half of 2014.
18. We note the Committee's concerns about the tension which can arise between insider trading rules and consultation of this kind. The Government will consider, working with the FRC and the FCA, whether more can be done to enable companies and investors to overcome these tensions successfully.

Remuneration of executives

The Government has accepted the principles underlying Professor Kay's recommendation on the remuneration of executives. We are therefore disappointed that it has failed to take the action to see it put into practice or responsibility for its implementation. We are not persuaded by the Government's view that businesses will see the benefit of this recommendation and will adopt this measure voluntarily.

We support the recommendation that company directors should be tied into the long-term performance of their companies through time-appropriate shares. Since the Government has accepted Professor Kay's analysis and agreed with his findings, it should reconsider its response and take an active approach to its implementation. In particular, we recommend that the Government outlines how it intends to combat the issue of directors using options and derivatives to avoid these rules. Alongside this the Government should outline how it will ensure that departing directors will not be perversely incentivised to artificially inflate the share price immediately prior to their retirement or retire early to realise the locked-in value of their shares. **(Paragraphs 52-53)**

19. Professor Kay's recommendation advocated long-term incentives for company directors that are genuinely linked to long-term business performance. The Kay report stated clearly that this should be achieved by promoting good practice by companies and not by mandating the structure of company directors' remuneration packages. The Government Response to the Kay Review endorsed this view. We believe that directors' remuneration is primarily for companies and their shareholders to determine; and that they need the flexibility to negotiate approaches that work for them.
20. We agree with the Committee's view that the Government has a role to play in creating the conditions for companies and their shareholders to agree simpler pay structures which are more clearly linked to long-term performance. For this reason, the Government has recently introduced comprehensive legislative reforms to the governance of directors' remuneration.¹ Their purpose is to boost transparency so that what people are paid is clear and easily understood, promote better engagement between companies and shareholders, and give shareholders more power through binding votes, so they can hold companies to account more effectively. The regulations, which come into force in October 2013, set out requirements companies must follow when reporting on directors' remuneration. Companies are required to prepare both a remuneration report, which sets out what each director has been paid in the previous financial year; and a directors' remuneration policy, to which companies will be legally bound, which sets out what each director could be paid and how those earnings are linked to performance and company strategy.
21. As noted in response to the Kay Review, the Government has already seen encouraging signs that institutional investors and companies are negotiating clearer expectations of remuneration policies which are simpler and more effectively linked to

¹ The Enterprise and Regulatory Reform Act 2013, available at: <http://www.legislation.gov.uk/ukpga/2013/24/contents>; and The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, available at: <http://www.legislation.gov.uk/uksi/2013/1981/contents/made>

long-term performance, including through the use of long-term share ownership as Professor Kay proposed. We expect this progress to continue following the coming into force of our reforms, and we will continue to work with business and investors to promote good practice and ensure the reforms have a lasting impact. The Government will keep this policy area under review, including in the context of forthcoming proposals from European Commission to amend the existing Shareholder Rights Directive. We expect this to include provisions aimed at improved transparency and shareholder votes on directors' remuneration, similar to UK reforms.

22. We understand Professor Kay's favoured approach to be that directors be required to hold shares, or be paid partly in shares, to be held for the long term, in order to provide a long-term incentive. He does not suggest that they be awarded shares or share options as a result of achieving performance targets. As the Committee's report suggests, share options can create incentives on directors to maximise the company's share price at the point at which options vest. Similarly, Professor Kay suggested shares should be held until sometime after the executive has left the company, precisely to avoid the issue, identified in the Committee's report, of directors seeking to maximise the share price ahead of leaving the company.
23. Accordingly shareholders scrutinising remuneration policies will wish to have regard to the possibility of such misaligned incentives emerging from the use of share options, or from the timing and structure of remuneration packages. We hope and expect that shareholders will frown upon the use by company directors of derivative financial instruments where these seek to hedge against the impact of poor performance on their shareholding in the company.

Incentivising fund managers

The incentives driving the actions of fund managers are one of the most important factors within the investment chain. Professor Kay made a specific recommendation on this but the Government has shied away from accepting it, citing an unwillingness to prescribe pay structures. While this may be understandable, it is clear that the Government must be involved; at the very least encouraging a cultural shift away from short-term to long-term performance-based pay.

We recommend that the Government takes a harder line when framing the culture in which fund managers work by highlighting best practice where it sees it. We further recommend that it should work towards the goal that fund manager performance be reviewed over longer time horizons than the typical quarterly cycle.

One way that the Government can help effect a culture change in the incentives driving fund-manager behaviour is to develop and publish a set of long-term measures of success alongside options for sanctions for demonstrable failure. We recommend that it does so, and then annually publishes a list of those firms that have fully adopted such measures. This would provide a different measure of success to the very short-term ones which are currently available. **(Paragraphs 62-64)**

24. The Government supports Professor Kay's view that asset managers' remuneration should be aligned with the interests and timescales of their clients. We are keen to see

asset managers adopt good practice in this area, and to consider in particular Professor Kay's suggestion that they should have long term holdings in the funds they manage. However we acknowledge that there needs to be flexibility to fit different fund types and structures.

25. We would like to see appropriate levels of transparency from asset managers so that their clients have reassurance that remuneration packages are aligned to their investment objectives. In this context, the Government notes that the National Association of Pension Funds (NAPF) has consulted on the development of a "Stewardship Framework" against which asset managers will be encouraged to self certify, indicating to pension funds and other clients the extent to which they fulfil a number of different categories of good practice in stewardship. The framework invites asset managers to indicate the extent to which manager remuneration is linked to long-term portfolio performance. This welcome initiative—which we understand will be launched imminently—aims to stimulate the market for stewardship by asset managers. It is a good example of the investment community developing good practice tools to change behaviour.
26. Alongside these efforts to encourage the development of industry good practice, recent developments at EU level—in the Alternative Investment Fund Managers Directive (AIFMD) and proposals for an updated Undertakings in Collective Investments in Transferable Securities (UCITS V) Directive—have also focused on asset manager remuneration. The Government is seeking to ensure that these also support alignment between fund manager pay and long-term performance.
27. The Government would like to see investors move away from the default use of short-term (including quarterly) relative performance metrics, towards metrics which focus on achieving returns in line with the long-term objectives of the end investor. We identify elsewhere in this response (at paragraphs 49 and 52 below) a number of welcome examples of industry responses to the Kay Review Good Practice Statements for asset managers and asset holders, which will contribute to this objective.
28. The Government has also commissioned research, to be completed by April 2014, into the uses and limitations of metrics and models used in the investment chain, from the perspective of long-term investors. We hope this will stimulate debate amongst investment practitioners and academia, inform the development of guidance for long-term investors, and identify aspects of regulation which may be driving the use of inappropriate metrics and models.

Quarterly reporting

We support Professor Kay's recommendation that the requirement for quarterly reporting should be removed and recommend that the Government now outlines a clear timetable to implement this recommendation including what alternative strategies would be followed in the absence of any change in EU law.

We recommend that the Government sets out details of progress in negotiations with other international accounting standard bodies (such as the U.S. Securities and Exchange Commission) on the requirement for quarterly reporting to ensure that any changes made to the domestic or EU-wide accounting practices are accepted on a global level. **(Paragraphs 70-71)**

29. With UK support, agreement has now been reached at EU level on amendments to the Transparency Directive which remove the requirement to publish interim management statements or quarterly reports.
30. The Government is committed to removing mandatory quarterly reporting for UK companies, and following publication of the new Directive in the Official Journal, intends to implement the relevant sections of the revised directive in the UK as soon as is practical.
31. This will involve changes to the Financial Conduct Authority (FCA) Disclosure Rules and Transparency Rules) following the FCA's statutory duties to conduct cost benefit analysis and consult.
32. The Government has asked the FCA to set out the timetable for this consultation process once the Directive comes into force.
33. The UK played a key role in successfully negotiating the changes to the Transparency Directive.
34. The Government continues to make the case for removing rigid requirements for quarterly reporting in international discussions, for instance at the OECD.

Over the longer term, the Government believes that the best way to make the case for this reform beyond the EU is to lead by example, to show that greater flexibility can improve, rather than diminish, the reporting of relevant and timely information to investors about the capacity of companies to create value over the long-term.

Narrative Reporting

We recommend that the Government sets out how it will ensure that enhanced narrative reporting will remain consistent with, and accepted by, overseas regulators, for example the US Securities and Exchange Commission.

When the proposed changes are made to the structure and format of reporting, the Government (through the Financial Reporting Council) will need to ensure that any accompanying guidance on the new provisions included clear minimum standards to ensure comparability. The Government must not shy away from strict enforcement of

these standards. The scrutiny and consistency of narrative reports may be harder than that of reports containing only information about pounds and pence, but the Government must ensure high standards are maintained. We therefore recommend that the Government outlines how it proposes to implement auditing and monitoring of narrative reports. Ongoing shareholder scrutiny and transparency must be at the heart of this. These processes must be in place before the proposed changes come into effect. **(Paragraphs 78-79)**

35. We welcome the Committee's support for the recommendation that "high quality succinct narrative reporting should be encouraged". As the report notes, the Government has introduced legislation² to restructure the annual report to help companies bring the strategic messages that are valued by shareholder and investors to the fore.
36. We are aware of the increasing disclosure burden on companies and we believe that for a narrative reporting framework to be effective, in meeting the needs of investors, it needs to provide companies with flexibility. Conversely, we believe that over-regulation of narrative reporting is likely to result in boilerplate and compromise high quality reporting.
37. The FRC is committed to improving the quality of financial reporting and would like to encourage annual reports to be more relevant to the needs of shareholders. The FRC's projects on narrative reporting, disclosure framework and cutting clutter contribute to achieving this objective.
38. BIS has asked the FRC to produce non-mandatory guidance to assist preparers with implementation of the new narrative reporting regulations. The non-mandatory nature of the guidance means that it contains principles for best practice. The draft encourages narrative reports to be concise, relevant to users and promotes greater cohesiveness in annual reports. It also encourages companies to experiment and be innovative in drafting annual reports to provide companies with flexibility.
39. The FRC's role is to enforce the statutory requirements relating to narrative reporting. Auditors will have a very limited role, in providing an opinion on whether information in narrative reports is consistent with the company's financial statements.
40. As the Committee notes, transparency and shareholder scrutiny are central to improving the quality and relevance of narrative reporting. The Government agrees: our view is that the dialogue between investors and companies about the shape and content of reports will be the single most important factor improving the quality of reporting, and will be more important than Government monitoring and oversight.
41. With respect to the international consistency of the narrative reporting framework, we appreciate that companies may encounter difficulties if they choose to list on multiple stock exchanges. Yet we feel that the costs and wider implications of bringing the reporting requirements fully into line with other nations would outweigh its benefits.

² The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, available at: <http://www.legislation.gov.uk/uksi/2013/1970/contents/made>

In any case there are a number of common areas between the US SEC requirements for Management Discussion and Analysis (MD&A) and the UK's requirements. The UK narrative reporting framework is also similar to the International Accounting Standards Boards 'Management Commentary'.

42. Finally, also worth mentioning in this context is the EU proposal on Non-Financial Reporting. This proposal, which is currently under negotiation, would aim to help comparability in non-financial reporting across EU member states.

The Stewardship Code: Content

Professor Kay recommended that the Code should be developed to take account of strategic issues as well as those around corporate governance. We recommend that this be implemented through a formal consultation by the Financial Reporting Council. It is essential that the Code is accepted by all players of the equity market. We recommend that the Code be enhanced:

- To allow investment managers to focus on strategic issues facing companies within their policies on how they discharge their stewardship responsibilities (rather than the current focus on profit, which is inherently short-term).
- To include the principle that engagement and corporate governance should extend beyond financial affairs and encompass more long-term value adding activities such as environmental, social and governance factors.
- To include the provision that institutional investors and significant owners should be members of at least one Investor's Forum.
- Related to the previous point, to include the role of institutional investors to engage in potential systemic risks to the UK equity market rather than only engaging with risks to individual companies in their portfolio.
- To redefine a clearer explanation of conflicts of interest and in particular for asset management firms to publish how key conflicts of interest are managed in practice.
- To provide one clear and authoritative definition of the term 'stewardship'.

(Paragraph 85)

43. The Government welcomes the Committee's views on the further development of the Stewardship Code. The revisions the FRC made to the Code in 2012 already incorporated a number of changes recommended in the Kay Review.³ The FRC is currently reviewing the implementation of the Stewardship Code, and has agreed to consider the Committee's recommendations in this context. The FRC is reviewing a sample of policy statements by signatories, as input to their annual monitoring report into development in corporate governance in the UK market due for publication at the

³ Note that the revisions made by the FRC to 2012 edition of the code reflected the specific recommendation in the Kay Review, that the code should incorporate a more expansive form of Stewardship, focussing on company strategy as well as questions of corporate governance. The existing Code also includes provisions covering effective management of conflicts of interest, and the consideration of environmental and social issues alongside corporate governance issues.

end of the year. Once this analysis is complete, the FRC will be better placed to consider how future editions of the Code can more effectively support the development of stewardship policies by asset owners when allocating investment mandates to asset managers, and whether further changes to the Code may be appropriate to align it with the Good Practice Statements published in the Government's response to the Kay Review. As with the Corporate Governance Code, any resulting proposed changes will be subject to consultation in the first half of 2014.

44. Turning to one specific point, we share the Committee's desire to consider whether collective engagement can be strengthened. The Stewardship Code already includes provisions on collective engagement. As noted above the FRC has agreed to consider the Committee's recommendations as part of its current review of the Stewardship Code. However we query whether the best way of achieving this objective is by including a provision in the Code requiring institutional investors to be members of at least one Investors' Forum. Existing investor bodies for collective engagement, and any new forum which is created, rely on a well-informed and highly-motivated membership to operate effectively. We are therefore concerned that such a provision would encourage investors to sign up to such fora simply to "tick the box", thereby potentially damaging the quality and credibility of the fora without improving the quality of the engagement.

The Stewardship Code: Sign-up

Progress has been made in terms of the number of asset managers signing up to the Stewardship Code. However, sign-up among owners remains low. We recommend that the Government:

- Outlines what it considers a minimum acceptable level of sign up to the Stewardship Code (making provision for the distinction between manager and owner).
- Makes clear that it is government policy to encourage sign-up to the Code and publishes a clear target (and timescale) of success. This timescale should be no longer than two years
- Outlines clearly what action it will take if this target is not met by the market on a voluntary basis.

Finally, some witnesses pointed out that, at the time of our inquiry, the Parliamentary Contributory Pension Fund (PCPF) was not signed up to the Stewardship Code. Penny Shepherd, Chief Executive of UKSIF, told us that "one area in which this House can act to raise awareness is by acting as an exemplar of good practice". We are pleased to take this opportunity to formally welcome the fact that the trustees of this fund have made the decision to sign up to the Stewardship Code in the near future. We will continue to monitor this. **(Paragraphs 89-90)**

45. The Government strongly encourages all relevant parties to sign-up to the Stewardship Code, which operates on a "comply or explain" basis. We believe this is key to achieving a critical mass of committed, long-term owners. We worry about setting specific targets for levels of sign-up to the Code which risks a tick-box

mentality at the expense of genuine commitment to stewardship. The majority of major asset management firms investing in UK equities have already signed-up to the Code, and asset manager signatories to the Code currently manage around 40% of the UK equity market. With such a significant proportion already signed up to the Code, we believe that Government action now needs to focus instead on ensuring lasting improvements to the behaviour of market participants.

46. We agree that more progress is needed to encourage asset owners to consider stewardship and to develop and implement stewardship policies when allocating investment mandates to asset managers. The Government is working with the relevant regulatory authorities and industry groups to consider what further steps would be appropriate to achieve this goal.
47. It has been suggested that pension schemes and other asset owners should be subject to a regulatory requirement to disclose the nature of their commitment to the Stewardship Code on a comply or explain basis, similar to that which applies to FCA authorized asset managers. We have not ruled out the possibility of such a measure. However it is equally important that asset owners such as pension schemes develop their understanding of stewardship and their capacity to effectively integrate it into their process for allocating investment mandates to asset managers. As noted in the previous section, further revisions to the Stewardship Code may support this objective.
48. The Government is also considering whether existing guidance and requirements on pensions schemes with respect to investment governance, including the Myners Principles, and the statutory requirements on pensions schemes to prepare a Statement of Investment Principles, could be better aligned with the Stewardship Code.
49. We also welcome the progress made by institutional investors on the development of industry good practice in this area. In particular:
 - We welcome the publication by the NAPF, in November 2012 of a Stewardship Policy, which reflects the Kay Good Practice Statements and is designed to encourage and enable pension schemes to understand and fulfil their responsibilities as investors and to sign-up to the Stewardship Code.
 - The NAPF has since consulted on the development of a “Stewardship Framework” against which asset managers will be encouraged to self certify, indicating to pension funds and other clients the extent to which they fulfil a number of different categories of good practice in stewardship. We expect this to be launched imminently.
 - The ABI’s recent paper on Improving Corporate Governance and Shareholder Engagement signalled support for the development of a “Stewardship Mandate” along similar lines.
50. The Government understands that the Parliamentary Contributory Pension Fund has now produced a statement of its stewardship policy and is now listed as a signatory to the SC. This is very welcome.

The Stewardship Code and Professor Kay's Good Practice Statements

We support Professor Kay's Good Practice Statements and agree that the industry, asset holders and company directors should be given the opportunity to formally embrace the principles that are contained within them. However, we are conscious that many individuals and firms are already signed up to the Stewardship Code and we are concerned that yet another voluntary compliance statement will be submerged by a rising tide of self-regulation and codes of best practice. The market requires clarity and certainty and we are concerned about over-burdening it with regulation and codes.

Professor Kay's Good Practice Statements should be the standard level of behaviour for the industry and all players in the UK equity market. We expect the Government, in its response to this Report, to outline its timetable for all companies to sign up to Professor Kay's Good Practice Statements. If this target is not met, the Government should be prepared to incorporate Professor Kay's Good Practice Statements into the already established Stewardship Code. **(Paragraphs 97-98)**

51. The Government's Response to the Kay Review set out the view that it did not intend the Good Practice Statements to have the force of regulation or a formal code. Rather the intention has been to use the Good Practice Statements as the starting point to encourage industry best practice initiatives which will deliver real outcomes in terms of culture change and to inform the further development of existing regulatory codes of practice such as the Stewardship Code.
52. We have seen good progress from business and the investment industry to develop good practice building on Professor Kay's recommendations. In addition to the initiatives noted at paragraph 49 above, we would especially highlight:
 - The Institute of Chartered Secretaries and Administrators (ICSA) published new guidance in March 2013 designed to improve the quality of engagement between investors and companies. This was produced by a steering group which involved the IMA and representatives of both institutional investors and companies, and reflected the relevant aspects of the Kay Good Practice Statements.
 - The GC100 and Investor Group⁴ issued best practice guidance to accompany the Government's reforms to the reporting of directors' remuneration in September 2013. It encourages constructive and informed engagement between companies and investors to support the long-term success of those companies.
 - The NAPF has also published a discussion document— jointly with Hermes Equity Ownership Services, the BT Pension Scheme, the Universities Superannuation Scheme and the Railways Pension Scheme—calling for simpler executive pay schemes, properly aligned with long-term success and a material investment by executives in the company.
 - The IMA has consulted on the introduction of a new Statement of Recommended Practice (SORP) for the financial statements of UK authorised funds. This will

⁴ The GC100 and Investor Group comprises the Association for the General Counsel and Company Secretaries of the FTSE 100 (GC100), the Association of British Insurers, and a number of leading pension schemes and investment firms.

include more comprehensive disclosure of fund performance and charges, including transaction costs, in line with Professor Kay's recommendation and Good Practice Statement.

53. The Government has also asked regulators to consider to what extent existing regulatory requirements may prevent the adoption of standards of good practice as defined in the Good Practice Statements, and what steps might be appropriate to enhance existing regulatory guidance and codes of practice accordingly.
54. The Pensions Regulator, for example, has recently issued a Code of Practice for trust-based defined contribution pension schemes. We understand that the accompanying guidance for Trustees, published this autumn, will be appropriately aligned with Professor Kay's Good Practice Statement for asset holders. We also understand that the Pensions Regulator will consider the Kay Review Principles, Good Practice Statements and directions for regulatory policy in the course of their work to update their regime for defined benefit pension schemes.
55. Moreover, as part of its current review of the Stewardship Code and the Corporate Governance Code, the FRC has agreed to consider what action may be appropriate to align the Code with the Good Practice Statements published in the Government's response to the Kay Review and whether it would be useful to incorporate elements of these statements into the Code.

Resourcing stewardship

The attitude of 'do the minimum possible' found in many of our institutional investment firms has hindered the development of good stewardship. Asset managers are currently allowed to use commissions to pay for long-term research, including long-term stewardship, but it appears that few are aware of this. We therefore recommend that the Financial Conduct Authority contacts all major institutional investors highlighting that long-term investment research that is orientated towards good stewardship could (and should) be paid for using a proportion of equity commissions reserved for research. Furthermore, we recommend that the FCA sets and publishes an appropriate minimum proportion of a firm's commission allocated to research that should be used towards such activities and an annual list of those firms which do not achieve that level. Those firms will be expected to comply or explain why they have not dedicated the recommended proportion of resources on good long-term stewardship. **(Paragraph 104)**

56. The Government is committed to encouraging asset managers to integrate stewardship fully within their investment process. The Kay Review Good Practice Statement for asset managers states that they "should build an ongoing relationship of stewardship with the companies in which they invest to help improve long-term performance..." Accordingly we support the view that such relationships should be effectively resourced by asset managers, and agree that research has an important role in supporting improved levels of stewardship activity in the UK market.
57. The Government has met with stakeholders and officials from the FCA and FRC to discuss this proposal.

58. The FCA has outlined that, under their existing regulations, asset managers are currently permitted to use dealing commissions to fund eligible third party research. FCA regulations indicate that asset managers can reasonably justify research as eligible under the use of dealing commission rules provided that: (i) it adds value to investment decisions by providing a fund manager with new insights; (ii) it involves original thought and intellectual rigour; and (iii) it involves analysis or manipulation of data to research meaningful conclusions.⁵ The FCA therefore believes that asset managers are already aware of their ability to fund research in this way, and that the type of research that is permitted can include the kind of long-term research supporting stewardship suggested by the recent Select Committee report, provided that it fulfils the evidential criteria set out above.
59. In addition, there is no restriction on the type of research or stewardship activities a fund manager may choose to fund directly themselves, as part of their investment management duties and obligations to act in the best interests of their customers. Fund managers who manage investments for professional clients are also required under FCA rules to disclose clearly on their website (or in another accessible form) whether they are committed to the FRC's Stewardship Code, and where they do not, specify their alternative investment strategy.
60. However, in the last 12 months the FCA (and its predecessor, the FSA) has expressed some concerns about the existing model which allows asset managers to use dealing commission to purchase research. The FCA's key concerns have been highlighted in a Dear CEO letter published in November 2012 and further work is expected to follow. The FCA's concerns in the letter included the lack of transparency, control over and accountability of fund managers' use of dealing commission to pay for external research, and the fact that many firms had a lack of adequate controls or incentives to effectively control these costs on behalf of their clients.
61. Following the FSA/FCA interest in this area, the Investment Management Association (IMA) is currently examining the issues relating to the use of dealing commission to fund research. We expect them to publish an interim report of options for reform to the regime in October 2013 and final proposals in early 2014. The FCA intends to engage further with the IMA and the wider industry on these issues to discuss their proposals and will also maintain a supervisory focus on asset managers in this area. Longer-term changes may also be forthcoming in EU level reforms to the Markets in Financial Instruments Directive (MiFID II), the proposals for which are currently in the final stages of negotiation between the European Parliament, Council and the Commission ('trialogues').
62. Given its concerns around the use of dealing commissions by asset managers under the current regime, the potential for EU reforms, and the IMA's Research Review, the FCA has said that it is not minded to adopt the recommendation to more clearly direct dealing commission to pay for long-term research. The FCA is expected to keep this area under review. The Government would welcome comments on the issues involved.

⁵ See FCA Conduct of Business Sourcebook, Chapter 11.6

63. More broadly, the Government shares the Committee's objectives that more should be done to encourage informed stewardship. Measures to promote collective engagement by investors, such as the creation of an Investors' Forum, aim to help by enabling investors to share the costs of engagement and stewardship, and to have a greater influence on companies than when acting alone.
64. Alongside this the Government aims to encourage a critical mass of committed, long-term investors—in particular through supporting the development of the FRC Stewardship Code—and to encourage a transparent dialogue between asset manager and asset holders about the costs and benefits of resourcing stewardship activities in the context of their long term investment objectives.

The Financial Transaction Tax

There was some support for the concept of a Financial Transaction Tax on trading practices such as High Frequency Trading. However, concerns were raised about the practicality of implementing such a tax unilaterally. We recommend that the Government considers the viability, benefits and risks of a Financial Transaction Tax and commissions research in the following areas:

- An impact assessment of the introduction of a Financial Transaction Tax on equities at a level which is the average profit made on a High Frequency Trade in the UK.
- A impact and feasibility study of the proposal to ban any of those banks which establish branches or subsidiaries in an offshore centre that does not adhere to the OECD's white list of financially compliant economies from trading in the UK. This should include an assessment of whether doing so would counter the arguments against a domestic FTT being ineffective in the global market.

(Paragraph 113)

65. The Government believes that any broad-based FTT would need to be implemented globally. However, international discussions have shown that such a consensus is not available. The main risk of proceeding with a broad FTT unilaterally is that firms and activities relocate away from the taxing jurisdiction. This risk would seem to apply to any foreseeable approach to implementing an FTT at a sub-global level, including to any approach which sought to place restrictions on UK firms relating to the countries they can do business with. On balance therefore the Government is not convinced there is a case for allocating resource to new research on these points at this time.
66. The Government has looked carefully at the risks and benefits of computer-based trading and, as the Committee mentions, commissioned a major research project from the Government Office for Science on the subject. This found that computer-based trading brought a number of important benefits to markets, as well as potential risks related to market instability. The package of new provisions in the upcoming MiFID II directive will, among other things, harmonise EU-wide regulatory standards surrounding computerised trading, while strengthening the related EU market abuse regime. The Government believes that a regulatory approach is a better way of

addressing the issues associated with High Frequency Trading than a financial transaction tax which is not implemented globally.

Mergers and acquisitions – UK policy and approach

Professor Kay recommended that the Government should take a more ‘sceptical’ view of the benefits of large takeovers and should be much more proactive in its monitoring of such activity. He drew particular attention to the relative vulnerability of UK companies to takeovers by foreign actors. We recommend that the Government conducts and publishes an assessment of the take-over regimes of other similar economies with a view to learning about the impact that takeovers have had on their companies and economies. Furthermore it should summarise which positive elements may be incorporated into our domestic system to strengthen our economy and ensure that takeovers benefit, rather than damage our economy.

The Government has accepted Professor Kay’s recommendation on mergers and acquisitions but it is unclear what specific action it will take. We recommend that the Government clarifies what actions it will take over the next six months to be in a position to effectively monitor all merger activity in the UK. In its response to us, the Government should outline what action it will take to engage with companies and their investors to ensure that any investment merger activity is to the long-term benefit of the UK economy. **(Paragraphs 119-120)**

67. The Government has always welcomed long-term foreign investment in Britain and continues to do so. Inward investment by foreign companies can benefit the UK bringing in new ideas, technologies and skills, stimulating productivity and growth in UK business and opening up markets for trade. Attracting investment to the UK from around the world is a vital element of the Government’s strategy to ensure sustainable long-term growth. Professor Kay agreed with this analysis when he argued against a general hostility to foreign ownership, acknowledging the continued importance of open markets for growth.
68. The Government has a variety of powers to engage in specific merger activity, set out in Part 3 of the Enterprise Act. The Government already uses these powers in exceptional cases to ensure UK interests are protected, such as where there may be national security issues.
69. The UK takeover regime is subject to the EU Takeover Bids Directive, which sets out common minimum standards for the conduct of takeover bids for companies whose shares are admitted to trading on a regulated market. The UK takeover regime is supervised by the Takeover Panel. The Takeover Panel conducted a review of aspects of the UK Takeover Code in 2010, and, in September 2011, made a number of changes to the UK regime to strengthen the position of target companies. The Panel has since reviewed these amendments (in November 2012) and found that they have operated satisfactorily.
70. The European Commission published a review of the application of the Directive by EU Member States in June 2012. The review concluded that, generally, the regime created by the Directive is working satisfactorily, and highlighted a number of issues

which the Commission is now exploring further with Member States. There are no plans for significant changes. The European Commission review also included a study comparing the EU framework with a number of other major jurisdictions, which showed that takeover bid legislation in those countries is based on similar principles to those in the Directive.

71. The Government accepted the recommendation of the Kay Review to keep the scale and effectiveness of merger activity under review. In particular we committed to improving engagement with companies and investors to promote investment which benefits the UK economy—including via the Government’s Industrial Strategy.
72. A key element of the UK’s approach is the Strategic Relationship Management Programme led by UK Trade and Investment. This is helping to establish better relationships with both foreign and domestic investors and key exporters. The Government has doubled number of companies enrolled in the SRM initiative since the autumn 2012, and will seek to double it again by 2015.

Mergers and acquisitions – The role and rights of short-term shareholders

We have heard evidence that the ‘one-share one-vote’ is fairest. Some witnesses pointed out to us that the long-term shareholders must choose to sell to short-term traders and argued that the ‘market’ ruled. However we cannot help but think back to the evidence that we have heard that, overall, takeovers detract value from companies. The Secretary of State told us that his instinct was to go back and consider introducing differential votes (i.e. encouraging the principle that short-term traders should have no influence over the takeover vote).

We recommend that the Department produces a feasibility study which clearly outlines the risks and benefits of introducing a policy that differentiates between shareholders and voting rights based on the length of time a share has been held. **(Paragraphs 125- 126)**

73. The Government supports the aim of ensuring the interests of those seeking short-term returns from a merger or acquisition do not override the long-term interests of the companies involved.
74. The proposal to disenfranchise short-term shareholders during a takeover bid appears initially attractive as a means to achieve this objective, though there are practical obstacles.
75. In response to the Committee’s recommendation, the Government has prepared a note setting out an analysis of this policy measure, which includes a summary of the analysis undertaken by the Kay Review and by the Takeover Panel as part of a review of aspects of the UK regulation of takeovers in 2010. This is attached at **Annex B** below.
76. We would welcome comments on the attached note. In particular, we would welcome suggestions about how the issues identified in the note, which prevent such policy measures being workable, could be overcome. The Government intends to convene a roundtable of stakeholders before the end of 2013 as a means to test this analysis.

Mergers and acquisitions – impact on UK companies

We further recommend that the Government commissions a study to set out the impact on the UK of foreign takeovers of British companies over the past 25 years. **(Paragraph 127)**

77. The Economic and Social Research Council (ESRC), which funds independent, high quality research on economic and social issues and is itself funded by the Government, commissioned a survey of the evidence on the impact on foreign ownership in 2011.⁶
78. The survey concluded that there are positive overall effects for UK competitiveness and business performance, and an overall positive effect on UK employment, from having an open economy. The survey identified that the experience of individual companies and communities vary and can involve both positive and negative consequences from a takeover, depending on other factors including the intentions of the acquiring company and the specific circumstances in the company and industry sector.
79. The Government continues to welcome long-term foreign investment in Britain. Its approach is consistent with that advocated in the survey: attracting targeted investment in UK industry, while expanding and improving the Government's strategic relationships with business, are important elements of the Government's industrial strategy and wider commitment to deliver sustainable long-term growth.
80. Given the importance of the subject matter, the Government will update this research in its progress report in summer 2014.

⁶ Economic and Social Research Council (ESRC) Evidence Briefing: Foreign ownership and consequences for British business, available at: http://www.esrc.ac.uk/_images/8-13313Foreign%20ownership%20and%20consequences%20for%20British%20business.pdf

Annex A: Summary of action to deliver the Kay Review

1. Note: In the section the Kay Recommendations are set out in thematic, rather than numerical order, under the following headings:
 - Specific policy measures
 - Areas of further policy analysis
 - Development of industry good practice
 - Ensuring regulation is informed by and aligned with the Kay Review

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| Specific policy measures: |
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Development of the Stewardship Code to emphasise that stewardship should focus on strategy as well as governance issues.

Kay Review Recommendation 1

Progress: Revisions made by the FRC to 2012 edition of the code reflected the specific recommendation in the Kay Review that the code should incorporate a more expansive form of Stewardship, focussing on company strategy as well as questions of corporate governance. Recommendation implemented.

Forward looking objectives: The FRC will consider whether further amendments are needed to reflect this recommendation in future editions of the Code. The FRC is currently reviewing the implementation of the Stewardship Code and any resulting changes will be subject to consultation in the first half of 2014.

Removing Mandatory Quarterly Reporting

Kay Review Recommendation 11

Progress: Amendments to the EU Transparency Directive to remove the requirement to publish interim management statements or quarterly reports have been agreed.

Forward Looking Objective: The Government intends to implement the relevant sections of the revised directive in the UK as soon as is practical. This will involve changes to the Financial Conduct Authority (FCA) Disclosure and Transparency Rules following the FCA's statutory duties to conduct cost benefit analysis and consult. The Government has asked the FCA to set out the timetable for this consultation process once the Directive comes into force.

Reforms to Narrative Reporting

Kay Review Recommendation 12 / Supports Kay Review Recommendation 6

Progress: The Government has introduced legislation to restructure the annual report to help companies bring strategic messages to the fore. The FRC is consulting on guidance which will encourage the development of best practice by companies in the preparation of concise reports which are relevant to users and form the basis of effective engagement and dialogue between companies and shareholders.

Forward Looking Objective: Regulations will come into force on 1 October 2013. We expect the FRC guidance to be finalised in early 2014. The Government will keep this policy area under review, and in any case will complete a post implementation review on the regulations in accordance with good practice.

Reforms to Governance of Executive Remuneration

Supports Kay Review Recommendation 15

Progress: Government has recently introduced legislative reforms to the governance of directors' remuneration which aim to increase companies' transparency and accountability to shareholders, and to empower them through the introduction of a binding vote. A key aim is to encourage companies and their shareholders to agree simpler pay structures which are more clearly linked to long-term performance.

Forward Looking Objective: Regulations come into force on 1 October 2013. The Government will continue to work with business and investors to ensure the reforms have a lasting impact. The Government will keep this policy area under review, and in any case will complete a post implementation review on the regulations in accordance with good practice.

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| Areas of further policy analysis: |
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The scale and effectiveness of merger activity of and by UK companies should be kept under review by BIS and companies themselves

Kay Review Recommendation 4

Progress: The Government accepted the recommendation and in particular is focused on improving engagement with companies and investors to promote investment which benefits the UK economy – including via the Government's Industrial Strategy. A key element of the UK's approach is the Strategic Relationship Management Programme led by UK Trade and Investment. This is helping to establish better relationships with both foreign and domestic investors and key exporters. The Government has doubled number of companies enrolled in the SRM initiative since the autumn 2012, and will seek to double it again by 2015. The new Competition and Markets Authority will also have the objective of long-term growth built into its performance framework.

Recommendation implemented.

Law Commission review of fiduciary duties in investment

Kay Review Recommendation 9

Progress: The Law Commission review is underway and progressing on track.

Forward Looking Objective: The Law Commission will consult, as part of its review project, by October 2013 and publish its report by June 2014. The Government will respond to the report in its progress report on the Kay Review in summer 2014.

Research on the uses and limitations of metrics and models for long-term investors

Kay Review Recommendations 13 / Supports Kay Review Recommendation 14

Progress: Professor Kay recommended that the Government commission a further independent review in this area. Given the technical nature and scope of the issues involved, the Government decided to instead progress this recommendation by commissioning a research project in this area. This research project is now underway. The Government has appointed an expert panel of academics and market practitioners to help shape the research, monitor its progress and quality, and promote wider engagement and debate.

Forward Looking Objective: The research project will be completed by 1 April 2014. The Government's objective is that it should:

- prompt debate about what metrics and models best inform long-term investment strategies for a range of different types of investor, setting the direction for further research;
- enable the development of Government and / or industry guidance for these investors; and
- enable the Government and regulators to identify where regulation may be prompting the use of unhelpfully short-term metrics and models.

Enabling Individual Direct Electronic Shareholding

Kay Review Recommendation 17

Progress: The Government committed to address this recommendation in the context of EU policy proposals relating to central securities depositories and securities law. Negotiations on these proposals are ongoing, and the Government is involved in discussions with the FCA and key stakeholders about practical options for direct electronic shareholding which would promote transparency and allow individual shareholders to exercise their rights.

Forward Looking Objective: The Government will provide an update on the progress of these discussions, and EU negotiations, in its progress report on the Kay Review in summer 2014.

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| Development of industry good practice: |
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2. The Government Response to the Kay Review advocated the development of good practice by companies and the investment industry based on the Kay Review Principles, the directions for market participants which follow from them, and the related Good Practice Statements for company directors, asset managers, and asset holders.
3. Below we set out examples of industry led initiatives which we hope will achieve the objectives of these recommendations, and our expectations for further progress. This is not intended to provide a comprehensive survey of the response from business and the investment industry: the Government's progress report in summer 2014 will provide a more detailed analysis of progress. We welcome these initiatives, and continue to work with market practitioners to encourage them to meet the challenge we set in the Government Response to the Kay Review.
4. As the Government Response to the Kay Review made clear, we will soon be commissioning a small group of respected senior figures from business and the investment industry to assess industry progress on shareholder engagement and stewardship, both collectively and individually. Their views will complement the Government's own progress report in summer 2014.

Promoting investor stewardship and meaningful engagement between companies and their shareholders

Kay Recommendations 2, 5, and 6

Progress:

- The Institute of Chartered Secretaries and Administrators (ICSA) published new guidance in March 2013 designed to improve the quality of engagement between investors and companies. This was produced by a steering group which involved the IMA and representatives of both institutional investors and companies, and reflected the relevant aspects of the Kay Good Practice Statements.
- The National Association of Pension Funds (NAPF) published a Stewardship Policy, in November 2012, which reflects the Kay Good Practice Statements and is designed to encourage and enable pension schemes to understand and fulfil their responsibilities as investors and to sign-up to the Stewardship Code.
- The NAPF has also consulted on the development of a "Stewardship Framework" against which asset managers will be encouraged to self certify, indicating to pension funds and other clients the extent to which they fulfil a number of different categories of good practice in stewardship. The framework invites asset managers to indicate the extent to which manager remuneration is linked to long-term portfolio performance.
- The Association of British Insurers (ABI) has recently published a paper on Improving Corporate Governance and Shareholder Engagement, which signalled support for the development of a "Stewardship Mandate" along similar lines.

- The Quoted Companies Alliance (QCA) has updated its Corporate Governance Code for Small and Mid-Size Quoted Companies which adopts key elements of the FRC's Corporate Governance Code and other relevant guidance and applies these to the needs and circumstances of small and mid-size quoted companies. It includes provisions to encourage positive engagement between companies and their shareholders.

Forward Looking Objective: The Government's progress report in summer 2014 will include analysis of industry initiatives in this area.

Improving collective engagement / establishment of an investors' forum

Kay Review Recommendation 3

Progress:

- As the Committee's report notes, a working group has been established, representing a range of perspectives within the investment industry, to look at issues of collective engagement and the establishment of an investors' forum.
- The ABI, whose members are represented on the working group, has also committed to expanding its existing collective engagement process to include all significant shareholders – whether or not they are ABI members. It is also setting up an “investor exchange” mechanism, to enable any significant shareholder to raise a concern on a particular UK listed company with other shareholders.

Forward Looking Objective: The working group is expected to report in November 2013. The Government will respond quickly to any issues it identifies for Government. We expect the industry to also act quickly and positively to take forward its recommendations as the basis for the creation of an effective structure for improving collective engagement by the end of 2013. If no such structure emerges, the Government will convene a conference of senior representatives from major UK institutional investors, early in 2014, to identify and resolve any outstanding barriers to progress in this area.

Improving cost transparency in the investment chain

Kay Review Recommendations 8 and 10

Progress:

- The Investment Management Association (IMA) has consulted on the introduction of a new Statement of Recommended Practice (SORP) for the financial statements of UK authorised funds which will include more comprehensive disclosure of fund performance and charges, including transaction costs and stock lending charges. This is in line with Professor Kay's recommendation and Good Practice Statement.
- Alongside this good practice initiative, the European Securities and Markets Authority has also issued guidelines for asset managers subject to the Undertakings in Collective Investments in Transferable Securities (UCITS) Directive. This requires transparent disclosure of stock lending charges and income, with income rebated to the client as the Kay Review recommends.

Forward Looking Objective: The Government would like to see these developments (alongside other cost transparency initiatives from the ABI and NAPF and others) deliver significant further progress by 2014, towards a comprehensive industry-led disclosure regime which provides clear information on costs and charges to all savers and investors throughout the investment chain, and irrespective of their choice of investment vehicle. The Government's report in summer 2014 will provide an update on progress in this area. The Government is prepared to consider further regulatory measures to improve transparency on costs and charges if insufficient progress is made.

Aligning company directors remuneration with business long-term performance

Kay Review Recommendation 15

Progress:

- The NAPF has also published a discussion document—jointly with Hermes Equity Ownership Services, the BT Pension Scheme, the Universities Superannuation Scheme and the Railways Pension Scheme—calling for simpler executive pay schemes, properly aligned with long-term success and a material investment by executives in the company.
- The GC100 and Investor Group⁷ issued best practice guidance to accompany the Government's reforms to the reporting of directors' remuneration in September 2013. It encourages constructive and informed engagement between companies and investors to support the long-term success of those companies.

Forward Looking Objective: The Government has already seen encouraging signs that institutional investors and companies are negotiating clearer expectations of remuneration policies which are simpler and more effectively linked to long-term performance, including through the use of long-term share ownership as Professor Kay proposed. We expect this progress to continue following the coming into force of our reforms this October. As noted above, we will continue to work with business and investors to promote good practice and ensure the reforms have a lasting impact.

Aligning asset managers remuneration with clients' investment objectives / timescales

Kay Review Recommendation 16

Progress:

- The NAPF Stewardship Framework described above invites asset managers to indicate the extent to which manager remuneration is linked to long-term portfolio performance.

Forward Looking Objective: The Government's progress report in summer 2014 will include analysis of industry initiatives in this area.

⁷ The GC100 and Investor Group comprises the Association for the General Counsel and Company Secretaries of the FTSE 100 (GC100), the Association of British Insurers, and a number of leading pension schemes and investment firms.

Ensuring regulation is informed by and aligned with the Kay Review:

5. In the Government Response to the Kay Review:
 - The Government committed to work with relevant regulatory authorities to explore to what extent the Kay Report's **directions for regulatory policy** are practical, and what changes in the law or in regulation might be therefore be appropriate.
 - In response to **Kay Review Recommendation 2**, the Financial Reporting Council (FRC), the Pensions Regulator (TPR) and the Financial Conduct Authority also committed to consider to what extent existing regulatory requirements may prevent the adoption of standards of good practice as defined in the Good Practice Statements, and what steps might be appropriate to enhance existing regulatory guidance and codes of practice accordingly.
 - In response to **Kay Review Recommendation 7**, the Government asked the FCA and to consider to what extent regulatory rules align the principle, set out in the Government Response to the Kay Review, that sought to define minimum standards of behaviour for all investment intermediaries.

6. We welcome further suggestions on possible measures to ensure the regulatory framework supports long-term investment in UK equities. Below we set out progress made to date:
 - The FRC has committed to reviewing the relevant provisions of the Corporate Governance Code, ahead of the next full revision of the Corporate Governance Code, to reflect the recent reforms to the governance of company directors' remuneration. The FRC is also reviewing the work of nomination committees, including on board appointments, and will consider whether changes are needed to the Code.
 - The FRC has agreed to consider what further action may be necessary to align the next edition of the Stewardship Code with the Kay Review Principles and Good Practice Statements. The FRC is currently reviewing the implementation of the Stewardship Code and any resulting changes will be subject to consultation in the first half of 2014.
 - The Government is working with the relevant regulatory authorities and industry groups to consider what further steps would be appropriate to encourage asset owners to consider stewardship and to develop and implement stewardship policies when allocating investment mandates to asset managers. The Government is also considering whether existing guidance and requirements on pensions schemes with respect to investment governance, including the Myners Principles, and the statutory requirements on pensions schemes to prepare a Statement of Investment Principles, could be better aligned with the Stewardship Code.
 - The Pensions Regulator has recently issued a new Code of Practice for trust-based defined contribution pension schemes. We understand the accompanying guidance for Trustees, published this autumn, will be appropriately aligned with

Professor Kay's Good Practice Statement for asset holders. The Pensions Regulator will consider the Kay Review Principles, Good Practice Statements and directions for regulatory policy in the course of their work to update their regime for defined benefit pension schemes.

- The FCA is conducting a review of the practices of asset managers with respect to both fund charges and conflicts of interest. We expect its current work programme and its renewed focus on conduct of business regulation to support achievement of the minimum standards set out in the Government's response to the Kay Review.
- The Department for Work and Pensions has recently consulted on minimum standards for workplace defined contribution pension schemes. The Government intends to make regulations in 2014, under a power in the current Pensions Bill, setting out minimum quality standards that workplace money purchase schemes would be required to meet.
- The Office of Fair Trading published the report of its study of the market for defined contribution pension schemes on 18 September which included recommendations on improving the standards of scheme governance and on improving the transparency of costs and charges on pension schemes. The Government will respond to the report's recommendations in due course.

Annex B: Summary of analysis of the policy proposal to disenfranchise short-term shareholders during a takeover bid

1. This note summarises the analysis of proposals to disenfranchise short-term shareholders during a takeover bid. This includes analysis undertaken by the Kay Review and separately by the Takeover Panel as part of a review of aspects of the UK regulation of takeovers in 2010.
2. The Government supports the aim of ensuring the interests of those seeking short-term returns from a merger or acquisition do not override the long-term interests of the companies involved. As such we do not oppose measures which reduce the influence of short-term shareholders in a takeover bid in principle.
3. The Takeover Panel's review helpfully summarised the arguments commonly made in favour of this proposal⁸:

“...it has been argued that the purpose of “disenfranchising” shares in the offeree company that are acquired during the offer period is to ensure that the outcome of takeover bids is determined by the core shareholder base, not by short term speculative investors who may acquire shares in order to facilitate the takeover. It is argued that ensuring that only those who are registered shareholders at the start of the offer period are eligible to “vote”⁹ on the takeover proposal would allow long term shareholders to accept the offer based on the long term interests of the company, without being “squeezed out” by speculators.

In addition, it is argued that the “disenfranchisement” of shares acquired during an offer period might have the effect of reducing acquisitions of offeree company shares by short term shareholders, by virtue of the fact that any shares acquired would not count towards satisfaction of the acceptance condition, and that reduced demand would lead to shares in the offeree company trading at lower prices (and at a larger discount to the offer price). As a result, existing shareholders would be deterred from engaging in “top-slicing” (i.e. selling a proportion of their shareholding as a hedge against the possibility of the bid failing) and a higher proportion of the register would remain in the hands of long term shareholders, who might be prepared to forego the short term gain available under the offer in favour of the prospect of long term value creation.

4. The Takeover Panel's assessment also identified a variety of arguments against such proposals, as well as a variety of other considerations and consequences in their consultation. In light of these issues, and in the face of strong opposition from stakeholders supporting the principle of “one share, one vote”, they decided not to introduce them in the Takeover Code.

⁸ The Takeover Panel review of certain aspects of the regulation of takeover bids: Consultation Paper, June 2010. Available at: <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/PCP201002.pdf>

⁹ It is important to note that shareholders only vote on a resolution to accept a takeover where it is achieved by a scheme of arrangement. In the case of a contractual takeover bid, shareholders “vote” only in the sense that they accept the offer to sell their shares.

5. The Government has similarly concluded that it would not be practical or effective to disenfranchise short-term shareholders during a takeover bid, for a variety of reasons. Drawing on the assessment made by the Takeover Panel and the Government's own analysis the most significant problems are described below:
 - i. First, there are practical problems identifying which shares have been disenfranchised, because shares in the UK are not individually identifiable. This is best illustrated with an example. Suppose a shareholder has owned 100 shares for 4 years and then purchases a further 10 shares during the period when short-term shareholders are disenfranchised, bringing his total shareholding to 110 shares. Because these shares are not distinguishable, if then sold 10 shares, a practical problem would arise in determining whether those 10 shares were deemed to be short-term or long-term holdings. It has been suggested that this problem could be overcome by applying a standard rule, but such a rule would be difficult to operate in an international market, with intra-day trading needing to be taken into account, but with share trading balances only struck at the end of the day.
 - ii. Similarly, because many shares are held by nominees, the underlying ownership of the shares might change without any change in the name of the register. In combination with the problem above this would make operating, and indeed enforcing, a disenfranchisement rule practically impossible.
 - iii. Furthermore, it would be easy to avoid disenfranchisement. Disenfranchisement would create an incentive not to trade in shares, but rather to trade off market in the economic interest in, and control of, the shares, which would be very difficult to police. The Government is currently consulting on measures to improve the transparency around the underlying beneficial ownership of companies, and we would be very concerned about measures which would encourage people to hide the deals they were doing in this way.
 - iv. It is also far from clear that disenfranchising short-term traders during a takeover bid would have the desired effect of strengthening the hand of those investors focused on the long term interests of the target (or acquiring company). Arbitrageurs will often seek to obtain a speculative position in a company before a takeover bid, and so would not be affected. Moreover, disenfranchising new shareholders to influence acceptance of a bid would prevent long-term shareholders seeking to reject a takeover from strengthening their opposition by acquiring more shares.
 - v. Additionally, contrary to the argument outlined in the extract above, removing the rights of shareholders to influence acceptance of a bid would arguably reduce the demand for a company shares, resulting in a lower share price and meaning hostile takeovers might be more likely to succeed.
 - vi. The disenfranchisement of shares acquired during a takeover bid could result in the decision as to the success or failure of a takeover bid being concentrated in the hands of one or a small group of shareholders in the target company.

While in some circumstances these shareholders might preserve the long-term interests of the company against a potentially damaging hostile bid, there is no guarantee that this would be the case: it might instead distort the price such shareholders were able to achieve, destroying value, or enable the entrenchment of existing management against the interests of other shareholders.

- vii. Finally, disenfranchisement of shares acquired during a takeover bid would appear to run counter to the provisions of the Takeover Bids Directive, replicated in the UK Takeover Code, that all holders of the securities of an offeree company of the same class must be afforded equivalent treatment. While this might be overcome if all shares were required to be held for a certain qualifying period before the attached rights could be exercised, the other issues noted above, and possibly other wider implications, would still arise.
6. The Kay Review also considered this issue and did not favour measures to disenfranchise short-term shareholders during a takeover bid. Professor Kay concluded that the presence of short-term “arbitrageurs” is not the central issue because they can only control shares that others have recently sold to them. He found existing shareholders are often willing to accept offers, even if they believe the offer price does not represent the long-term value of the shares, because they are too often focussed on short-term relative returns. He therefore proposed that the best and only means to prevent this is to encourage more asset managers to adopt investment approaches based on stewardship and the pursuit of absolute long-term returns.
 7. The Government would welcome comments on the attached note, and would welcome in particular suggestions about how the issues identified in the note, which prevent such policy measures being workable, could be overcome