International
Capital
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Association

ICMA

ASSET MANAGEMENT AND INVESTORS COUNCIL

Professor John Kay
The Kay Review
Department for Business, Innovation and Skills
Spur 2, Floor 3
1 Victoria Street
London, SW1H 0ET

November 18, 2011

Sent by email

Dear Professor Kay,

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

The ICMA Asset Management and Investors Council (AMIC) was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

Taking into consideration the changes that have occurred in the industry, the AMIC composition embraces the diversification and the current dynamics of the industry – taking the asset management representation to a broader and global level. The AMIC is concerned by issues affecting investors-led organisations rather than issues related to fund distribution.

The AMIC welcomes the opportunity to respond to the Kay review of UK Equity Markets and Long-Term Decision-Making. The AMIC has been very interested and engaged in the issue of shareholder participation. We believe that there is a need for an effective corporate governance framework, particularly one based on the premise of 'comply or explain'. Institutional investors have been criticised for not exercising their responsibilities as shareholders and failing to hold boards to account for their activities. Regulators have called upon institutional investors to be more proactive in engaging with the management of companies. The need for the industry to improve in this area has been recognised by the AMIC. We believe that it is good practice to be transparent (and publish voting records for instance) and to ensure that clients are made aware of certain issues to be voted on.

However, whilst being engaged is part of the commitment when taking a stake in a company, it is important to emphasise that asset managers are not the ultimate owners of the assets. Any regulation trying to regulate the agents as a proxy for encouraging desired behaviour by principals may be counterproductive, as agents have a fiduciary role and can only act on behalf of their clients as contractually agreed. If principals

decline to empower agents, or go further and positively instruct them not to act, agents have no authority to follow regulators' instructions to do otherwise.

The AMIC has responded to questions affecting its membership.

1. Whether the timescales considered by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and asset managers in making investment and governance decisions, match the time horizons of the underlying beneficiaries.

d. *The relationship between reporting timescales and those used for internal planning and appraisal;*

When making investment and governance decisions timescales are taken into account. However they depend on the nature of the corporate investment in question. We have identified three main types of investments: mergers and acquisitions; investment in people; and investment in infrastructures. Each category will be analysed according to different timescales. In the case of M&A transactions, investors will be expecting quick returns, on a timescale of 18 to 24 months. Beyond this period it is difficult to assess the real impact of the transaction. In the context of investment in 'people' – that would include research and development and training for instance - this relates to sustainability and belongs to a long-term horizon. As regards physical infrastructures, a classic discounted cash flow analysis will be typically followed as well as the analysis of the return on investment. This could be considered in a timescale of 5, 10 or 20 years depending on the investment.

2. How to ensure that shareholders and their agents give sufficient emphasis to the underlying competitive strengths of the underlying competitive strengths of the individual companies in which they invest

a. *How equity analysts and asset managers assess the competitive advantages of companies;*

Investors follow a classical analysis of what the clients of the company, the competitors, and the management are saying, as well as considering research and development budget and other expenditure in comparison to competitors. Investors will also be looking at the management track record of proven execution capacity.

b. *The extent to which trading on equity markets is guided by analysis of underlying corporate performance, and the extent to which it is driven by analysis of short-term market trends;*

The AMIC is surprised by the questions as members invest on the basis of analysis, and therefore do not trade, as explained in question 2a. Corporate performance is key rather than short-term market trends. We feel that this question should be rephrased.

c. *How have technological advances such as automated trading affected investment decisions in equity markets;*

The AMIC does not think that technological advances, such as automated trading

have affected investment decisions.

3. Whether the current functioning of equity markets gives sufficient encouragement to boards to focus on the long-term development of their business.

a. Whether changes in reporting obligations have influenced the perspectives and timescales of managers and boards, and whether these changes in perspectives and timescales help or hinder long-term decision-making;

The AMIC believes that this is a very relevant question. There is clear evidence that the change from annual reporting to semi-annual to quarterly reporting has profoundly changed the investment horizon of the public. Managers and boards are now compelled to review their initial decisions on a more frequent basis.

c. Whether publicly traded companies pay too much attention (or feel obliged to pay too much attention) to short-term fluctuations in their share prices;

Publicly traded companies are subject to a constant flow of information. And although the AMIC feels that they do pay too much attention to short-term fluctuations in their share prices, we believe that this is due to the nature of the environment they are in. They are forced to consider the press and investors' concerns on a permanent basis.

5. Whether Government policies directly relevant to institutional shareholders and fund managers promote long-term time horizons and effective collective engagement.

a. Whether pension regulation, insurance regulation, supervision of charitable endowments and regulatory requirements for asset managers lead to excessive emphasis on benchmarking and on short-term performance measurement.

Clearly all current legislative proposals give an excessive emphasis on the debt market away from equities. Solvency II favours a mark-to-market rather than buy-and-hold view of investment risk. The new regime will also make it more expensive for all European insurers to hold assets such as equities, property and long-term bank debt. This will likely force them to reallocate assets en masse and could perhaps trigger fundamental shifts in demand and pricing across interest rates, credit and equities. Similarly mark-to-market valuations have driven pension funds to focus on short-termism and failed to take into account the length of their investment horizon.

Institutions affected by these regulations and accounting rules are already selling equities at the wrong phase of the cycle, which is damaging value – in preparation for an increase in the regulatory burden and supervision. It has led to a focus on short-term performance measurement and on responsibilities towards supervisors and pension members. In this context, asset managers are now asked to beat the market on a short-term horizon - 2 ½ year period - rather than 6/7 years.

c. Whether the regulation of contact between companies and investors is an obstacle to effective engagement.

The AMIC feels that it has been difficult to have effective engagement with companies on the basis that they are unable to mention anything that has not yet been reported in the press, or are scared about being liable for spreading insider information.

6. **Whether the current legal duties and responsibilities of asset owners and fund managers, and the fee mad pay structures in the investment chain, are consistent with these long-term objectives.**

a. *Whether there is a more rapid turnover of asset managers and whether this makes it more difficult for these managers to take a long-term view of the companies in which they invest;*

The AMIC discussed this in responses to questions 5a and 5b. We would like to emphasise that asset managers are now asked to beat the market in 2 and a half years, or lose the mandate.

b. *How individual asset managers are rewarded, and their performance measured, and whether this gives insufficient incentive for them to take a long-term view of the companies in which they invest;*

The industry represented by the AMIC has a fiduciary duty towards its clients. The way asset managers are compensated therefore is aligned with clients' interests and their longer-term time-horizons: asset management is a multi-year business rather than a transactional business and remuneration arrangements already reflect this, with variable pay being based on a multi-year performance rather than a one-year record of transaction-driven profits. As a result, the time period on which an asset manager's performance is based is more likely to be of 2 - 3 years.

The aim for asset managers is to achieve repeat business and this is done by achieving good performance over a longer time. The AMIC has called at European level for a principle-based approach to remuneration policies targeted at asset managers to ensure adequate flexibility. The response of many asset managers to recent market events has entailed variable pay that varied downward, in some cases quite sharply, to protect core staff resources over the years of lower revenues: this ensured that the long-term structure of asset managers (necessary to align asset managers with clients' long term performance requirements) was not put at risk by short-term revenue dips.

c. *Whether there are agency problems in the objectives and operations of asset managers that may be deleterious to the interests of the corporate sector or savers;*

Institutional investors have been criticised for not exercising their responsibilities as shareholders and failing to hold boards to account for their activities. Regulators are calling upon institutional investors to be more proactive in participating in the management of companies. The members of the AMIC recognise that the industry needs to improve in this area. However, there is little objective evidence that engagement produces superior portfolio returns and yet it comes with a cost. Indeed, the separation of ownership and control raises fundamental questions about representation of interests.

The AMIC believes that good corporate governance does not necessarily imply activism, and no proposal should encourage the buy-side to be activist. Some asset managers decide to follow an investment policy based on activism to ensure positive investment returns. But there are in fact different options for asset managers once they have bought shares. They may understand the management's strategy and agree with it, or disagree and then decide to engage with the management. Asset managers would take a view on the company's future, and may choose to engage with the company. A number of outcomes are possible. Management may choose not to listen, or asset managers may give wrong advice. Asset managers may also choose to sell their shares. If a possible legislative proposal were to be drafted, this flexibility should be maintained. The AMIC believes that this is a complex issue and that it is difficult to actually quantify 'the return on engagement'.

The AMIC welcomes efforts that have been made to improve corporate governance standards through market-led initiatives such as the UK FRC Stewardship Code. One of our members has explained that their engagement on behalf of their clients is based on a dialogue with companies; voting records are published on the web with a three-month delay; and full-time skilled members of staff employed to oversee the whole process.

Although the AMIC considers that being engaged is part of the commitment when taking a stake in a company, it is important to emphasise that asset managers are not the ultimate owners of the assets. Any regulation trying to regulate the agents as a proxy for encouraging desired behaviour by principals may be counterproductive, as agents can only act on behalf of their clients as contractually agreed. If principals decline to empower agents, or go further and positively instruct them not to act, agents have no authority to follow regulators' instructions to do otherwise. Sovereign Wealth Funds (SWFs) are for instance known as often preferring to be passive owners, and asset managers have to be able to respect this choice without being in breach of well-intended regulation. There would be a litigation risk if clients' wishes were not respected by the agent because of the agent's regulatory obligation to vote on its clients' behalf. Pooled funds complicate matters further, as there may be multiple principals behind the fund and following the owners' wishes, or even ascertaining them, is not always practical.

Legislative proposals would in effect turn the shareholder's <u>right</u> to direct their company's management into an <u>obligation</u> to do so, for the common good. This would make common equity less attractive to many holders (and to some SWFs in particular, much less attractive). This would be reflected in the market, firstly by a lower price for common equity, and secondly by a reorganisation of the capital structure of public companies. In effect, if regulators demand that holders of common equity take on certain responsibilities, then companies will inevitably find a way of issuing equity which does not carry these burdens, so as to attract investors who for their own legitimate reasons do not wish to actively engage.

Asset managers have clients worldwide, all subject to different sets of rules. The AMIC believes that it is good practice to be transparent (and publish voting records for instance) and to ensure that clients are made aware of certain issues to be voted on.

Moreover, no asset manager has the resources to vote on all issues of every

company its clients hold a stake in. Therefore it is important to emphasise the costs active engagement entails – costs that would inevitably be passed onto the ultimate asset owners in the form of higher fees, raising again the question of whether some principals would accept the extra charges, especially if they did not intend to exercise their rights to vote.

d. *How other intermediaries and market participants are remunerated and what impact this has on their incentives and those of their clients.*

The AMIC recognises that this is an important question. However they feel that the RDR could potentially take care of this. The AMIC believes that there are currently too many agents to serve retail investors, and the cost of advice has been too high. However it is expected that the implementation of the RDR will reduce these costs.

7. **Whether there is sufficient transparency in the activities of fund managers, clients and their advisors, and companies themselves, and in the relationships between them.**

b. *Whether asset managers should be subject to more extensive disclosure requirements, e.g. of costs and remuneration structures;*

The AMIC has no problem in principle to disclose costs and remuneration structures. However the AMIC believes that this should be done in a context of disclosure and transparency applied across sectors rather than an asset management specific policy.

c. *Whether the growth of investment consultants has encouraged or discouraged engagement by share owners with companies;*

The AMIC does not believe there is any link.

d. *Whether the overall costs of intermediation are understood by beneficiaries, and are proportionate to the value of the services provided;*

The AMIC refers to its response on 6d. The AMIC agrees that there is no enough disclosure regarding the overall costs of intermediation. Moreover the costs seem to be disproportionate in comparison to the services provided – as the fee is implicitly included. However as aforementioned the RDR should address this issue.

9. **The impact of greater fragmentation and internationalisation of UK share ownership, and other developments in global equity markets, on the quality of engagement between shareholders and quoted companies.**

a. *What has been the effect of the internationalisation of UK equity markets on the priorities of companies and fund managers;*
b. *Whether the growth in overseas ownership of UK equities and in the overseas activities of UK listed companies, has affected engagement between UK investment institutions and UK companies.*

The AMIC does not believe that the internationalisation of UK equity markets have changed the priorities of companies or the engagement of UK investors. Although

there may be less UK company/UK investor meetings, this is due to the smaller proportion of UK investors and increasing number of foreign investors. The AMIC does not believe in the underlying premise that internationalisation of UK equity markets has had a damaging effect on the market. In fact the more diverse the pool of people companies engage with, the more perspectives and international standards UK companies will be faced with. The AMIC believes that this will eventually improve corporate governance standards.

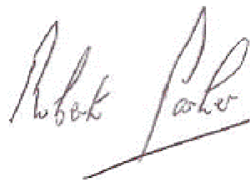
10. Likely trends in international investment and in the international regulatory framework, and their possible long-term impact on UK equity markets and UK business.

a. *How UK asset managers, and UK companies, expect the pressures on them to change with further internationalisation of equity investment;*
b. *Whether recent or planned regulatory actions by authorities outside the UK, and particularly regulatory policy developments at EU level, will affect engagement between asset managers and the companies in which they invest and the ability of companies to respond to that engagement.*

International regulatory changes have enabled a greater access to the capital market. However they have also meant falling holdings by UK based pension funds and insurance companies – because of specific regulatory frameworks – and no corresponding uptake of UK shares by other investors. The AMIC would suggest that the overall cost of capital in the capital market will go up.

The AMIC would be happy to discuss further with you the points made in this letter. The Secretary of the AMIC, Nathalie Aubry-Stacey, can be reached at Nathalie.aubry-stacey@icmagroup.org should you need further information.

Yours sincerely,



Robert Parker
AMIC Chairman