Kevin Campbell*

Responsible Capitalism and the Culture of Investment

Introduction

In the wake of the financial crisis triggered by the collapse of Lehman Brothers in 2008 and the subsequent economic downturn a number of reviews have been commissioned into corporate governance and related matters. For example, the U.K.'s *Turner Review* in March 2009 concluded that the complexity of large banking groups made it difficult for non-executive directors to fully understand the risks taken by the executive directors [Financial Services Authority, 2009]. The *Walker Review* of corporate governance in U.K. banks and other financial institutions, published in November 2009, suggested that steps be taken to improve the engagement between institutional investors and the boards of their investee companies [Walker, 2009]. It proposed that institutional investors and their agents should sign up to a new code of conduct formalising their rules of engagement with investee companies. This proposal was duly enacted by the Financial Reporting Council (FRC) the U.K.'s independent regulator responsible for promoting corporate governance and reporting when it published a revised and renamed *UK Corporate Governance Code* (formerly called the *Combined Code*) in May 2010, from which Section E (relating to institutional investors) was removed and replaced by a separate *UK Stewardship Code*, published in July 2010.

The most recent U.K. independent review was commissioned in June 2011 when the U.K. Government asked Professor John Kay to investigate investment in U.K. equity markets and its impact on the long term performance and corporate governance of U.K. quoted companies. The principal concern was to determine whether U.K. equity markets enhance the performance of U.K. companies and enable savers to benefit through returns to direct and indirect ownership of shares in these companies. In July 2012, the *Kay Review of UK Equity Markets and Long-Term Decision Making* (hereafter the Kay Review or the Review) was published. It concluded that short-termism is a problem in U.K. equity markets and that the principal causes are the decline of trust and the misalignment of incentives throughout the equity investment chain. It sets out principles that are designed to

* PhD, Division of Accounting & Finance, Stirling Management School, University of Stirling, FK9 4LA Scotland UK, kevin.campbell@stirling.ac.uk

provide a foundation for a long-term perspective in U.K. equity markets and describes the directions in which regulatory policy and market practice should move. These high level statements are supported by 17 specific recommendations that aimed to provide the first steps towards the re-establishment of equity markets that "work well for their users" [Kay Review, 2012, p. 9].

The Government's response to the Kay Review, published in November 2012, is overwhelmingly supportive in principle, if not in detail, of the recommendations aimed at, in the Government's words, "reversing the culture of short-termism and restoring relationships of trust and confidence in the investment chain" [Department for Business Innovation and Skills, 2012]. In a related development, the U.K.'s Financial Reporting Council published a revised *UK Stewardship Code*, which took effect on 1 October 2012. Acknowledging the Kay Review agenda, the revised UK Stewardship Code reinforces the importance of improving levels of trust between companies and their owners.

The need for appropriate stewardship by managers (agents) acting on behalf of investors (principals) can be explained in the context of agency theory, which holds that managers may engage in self-serving behaviour that destroys investors' wealth. Shareholders can control agency costs by the use of various corporate governance mechanisms. These include: monitoring by boards of directors, e.g. [Fama and Jensen, 1983]; monitoring by large outside shareholders, e.g. [Demsetz and Lehn, 1985; Holderness and Sheehan, 1988]; and equity-based managerial incentives to align the interests of agents and principals [Murphy, 1985; Jensen and Murphy, 1990]. Managerial opportunism may also be constrained by the threat of takeover, e.g. [Grossman and Hart, 1988; Shleifer and Vishny, 1997] and competition on the product [Hart, 1983; Jensen, 1993] and managerial labour markets [Fama, 1980]. The focus on this paper is on explaining why investors should be encouraged to play an active role as monitors of managerial performance and how the recommendations of the Kay Review may assist in achieving this objective.

The paper is organized as follows. In Section 1 the main conclusion of the Kay Review are presented, namely the problem of short-termism and its sources – the decline of trust and the misalignment of incentives throughout the equity investment chain. The fiduciary duties of agents in the equity investment chain are also discussed. The paper then picks out and discusses key issues considered in the Review. Section 2 discusses the role of company directors while Section 3 discusses the role of asset managers. Section 4 then considers the role of asset holders, while Section 5 concludes.

1. Short-termism in UK equity markets and its sources

In its response to the Kay Review, the U.K. Government accepted Professor Kay's analysis and the conclusions of his report [Department for Business Innovation and Skills, 2012]. It endorsed the 10 Kay Review Principles set out in page 12 of his report, which it renamed the *Principles for Equity Markets* (see Appendix A). It also indicated its willingness to work with relevant regulatory authorities to explore further the Kay Review's directions for regulatory policy, to identify to what extent these directions are practical and what changes in the law or in regulation might be therefore be appropriate, and how these might best be delivered. The U.K. Government also accepted in principle the 17 *Kay Review Recommendations* (see Appendix B). These are aimed variously at market participants, government and regulatory authorities, and are regarded the first steps towards ensuring that UK equity markets fulfil their core purposes.

The Review charts the decline in the role of the individual shareholder over the last quarter century and notes that this has been paralleled by an explosion of intermediation.

Between the company and the saver are now interposed:

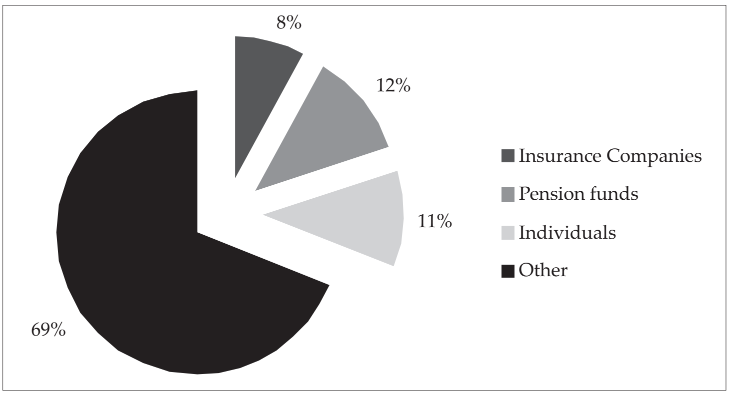
- registrars,
- nominees,
- custodians,
- asset managers,
- managers who allocate funds to specialist asset managers,
- trustees,
- investment consultants,
- agents who 'wrap' products,
- retail platforms,
- distributors,
- independent financial advisers.

Each of these agents must employ its own compliance staff to monitor consistency with regulation, must use the services of its own auditors and lawyers and earn sufficient to remunerate the employees and reward its own investors. According to the Review, a key driver of the growth of intermediation has been the decline of trust and confidence in the investment chain. For example, the role of custodian came into being because the asset manager could not be trusted to hold shares on behalf of the ultimate shareholder.

Turning now to the key message of the Kay Review, short-termism in business is defined "both as a tendency to under-investment, whether in physical assets or in intangibles such as product development, employee skills and reputation with customers, and as hyperactive behaviour by executives whose corporate strategy focuses on restructuring, financial re-engineering or mergers and acquisitions at the expense of developing the fundamental operational capabilities of the business" [Kay Review, 2012, p. 10]. The Review notes that there are many examples of companies that have made poor long-term decisions, and argues that equity markets have evolved in ways that contribute to these errors of managerial judgment. It concludes that the *quality* – not the *amount* – of engagement by shareholders determines whether the influence of equity markets on corporate decisions is beneficial or damaging to long-term company interests. Public equity markets are seen as currently encouraging exit (the sale of shares) over voice (the exchange of views with the company) as a means of engagement, replacing the concerned investor with the anonymous trader.

The Review charts the evolution of the structure of shareholding in UK equities, observing an increased fragmentation of share ownership. This is driven by a diminishing share of equities held by UK insurance companies and pension funds and by the globalisation of financial markets which has led to increased foreign shareholding (see Figure 1). This fragmentation has reduced the incentives for engagement and the level of control enjoyed by each shareholder. At the same time, there has been an explosion of intermediation in equity investment, driven both by a desire for greater professionalism and efficiency and by a decline in trust and confidence in

Figure 1. FTSE 100 Ownership by Beneficial Owner Type (percentage of total value)



Source: [Kay Review 2012, p. 32].

the investment chain. The growth of intermediation has led to increased expenses for investors, an increased potential for misaligned incentives and a tendency to view market effectiveness through the eyes of intermediaries rather than companies or end investors.

The Review notes that the equity investment chain will best serve the interests of savers and companies if relationships along it are based on the concept of stewardship. Stewardship entails mutual confidence based on trust in the agent with whom money has been placed, and respect by that agent for the saver whose money has been placed. The promotion of stewardship requires that the responsibilities of agents should be defined in ways that establish and reinforce trust and respect. Stewardship is incompatible with conflict of interest. The Review states that "trust in an investment chain will be as strong as the trust in the weakest link of that investment chain" [Kay Review, 2012, p. 65].

Many respondents to the Review raised the question of the *fiduciary* character of relationships in the equity investment chain. There was evidently considerable uncertainty and difference of view among respondents as to whether a fiduciary duty exists in these relationships. The concept of fiduciary duty is a creation of common law. The Review quotes case law that identifies a fiduciary as 'someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence' [Kay Review, 2012, p. 65].

Whereas pension fund trustees have common law fiduciary obligations by virtue of the trust deed which governs the scheme and company directors have specific statutory fiduciary obligations defined by the *Companies Act 2006*, the legal position of other intermediaries is less clear. However, fiduciary relationships may well be found at every point in the equity investment chain where there is either advice or power to act. The Review notes that many asset managers were clear that their relationship with their client had a fiduciary character but that other intermediaries were not so clear. Others, including some asset managers, took the view that their relationship with clients was defined by, and limited to, the contract between them.

The Review is quite clear on this matter, stating that:

- regulatory obligations in the equity investment chain should be raised to fiduciary standards,
- the application of the legal concept of fiduciary duty to investment matters should be clarified.

It notes that the standard implied by fiduciary duty, loyalty to a customer, contrasts with the corresponding regulatory obligation in Principle 634 of the FSA, that "a firm must pay due regard to the interests of customers and treat them fairly" [Kay Review, 2012, p. 67]. It further notes that the regulatory principle governing conflict of interest is that "a firm must manage conflicts of interest fairly" [Kay Review, 2012, p. 67]. The latter obligation is elaborated as requiring the firm to identify conflicts, and to disclose them, on request or if the firm believes itself unable to manage them effectively. The Review states forcefully that "these duties fall materially below the standards necessary to establish the trust, confidence and respect characteristic of stewardship" [Kay Review, 2012, p. 67].

As the FSA's principles are substantially influenced by E.U. legislation, the Review has called for the regulatory authorities at both E.U. and U.K. level to review the extent to which existing regulation promotes relationships of trust and confidence and to orchestrate a shift to fiduciary standards. In its response to the Kay Review, the U.K. Government notes that since the Review was published there has been much discussion of the meaning and scope of the word "fiduciary". Many interpret it in the strict legal sense of a relationship in which the principal is reliant or dependent on the knowledge, expertise and discretion of an agent, and to which the strictest duties of loyalty and prudence are applicable, while others use of the word fiduciary to describe a more general duty of care. In order to provide clarity that these standards should apply universally, the U.K. Government decided to avoid using the word "fiduciary". Instead it has proposed the following principle for equity markets, which it believes reflects Kay's Good Practice Statements for Asset Managers and Asset Holders (Appendices D and E):

"All participants in the equity investment chain should act:
- in good faith,
- in the best long-term interests of their clients or beneficiaries,
- in line with generally prevailing standards of decent behaviour.

This means ensuring that the direct and indirect costs of services provided are reasonable and disclosed, and that conflicts of interest are avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary.

These obligations should be independent of the classification of the client. They should not be contractually overridden" [Department for Business Innovation and Skills, 2012, p. 9].

2. The role of company directors

The fourth principle set out in the Kay Review (see Appendix A) is that:

Company directors are stewards of the assets and operations of their business. The duties of company directors are to the company, not its share price, and companies should aim to develop relationships with investors, rather than with 'the market'.

The obligation of directors to promote the success of their company in the long-run corresponds to the concept of stewardship, i.e. the idea that the director is the steward of the assets and activities of the company. The obligations of the director are to the company and relate to the assets and activities of the company. In contrast, the obligations of the asset manager or asset holder are to the saver whose money is invested in his or her funds and subsequently in the shares of the company. The Kay Review points out that there is a clear difference: the company director is not a "meta-fund manager", handling a portfolio of investments on behalf of a saver.

The Review suggests that stewardship should be broadly understood to include engagement on aspects of company strategy, rather than simply on compliance with corporate governance standards (see Appendix C). This view is also reflected by the FRC in its 2012 update to the *UK Stewardship Code*.

One area in which company directors have a key role to play is in deciding whether to engage in takeovers or whether to accept a takeover offer if their company becomes a target The Review notes, with regret, "the tendency for some chief executives to be preoccupied with deal-making rather than developing competitive advantages in operating businesses" [Kay Review, 2012, p. 60]. It argues that the 'market for corporate control' cannot be relied on to ensure that the management of companies is always placed in the most capable hands as there are too many instances of failed transactions.

There were two principal concerns expressed by those who responded to the Review about directors' duties when their company is the subject of a takeover bid:

1. Can the directors legally recommend that a high bid be rejected?
2. Does it matter anyway, since the bid is likely to be accepted by shareholders?

The answer to the first question is yes, as company directors must have regard to the long-term success of the company for the benefit of its members, as clearly stated in the U.K. *Companies Act 2006*. The second issue, however, raises wider matters of public policy. In a number of controversial contested bids, the outcome has been settled by arbitrageurs, often hedge funds, who have appeared on the share register with the sole objective of speculating on the bid being accepted. One way to tackle this issue would be to deprive such arbitrageurs of votes. However, the Review argues that the presence of arbitrageurs is not the central issue as they can only vote shares that others have recently sold to them. Rather, the key problem is that the underlying holders of shares are unwilling to reject an immediate offer at a premium to the previous share price even if they believe that the still higher fundamental value of the share will be revealed in the long-run. Or that they have no idea of the fundamental value of the share, but "take the money and run" [Kay Review, 2012, p. 61]. The development of stewardship activity by asset managers is the best safeguard against such actions.

The Review recommends, inter alia, that company directors should acknowledge the relevance of considering long-term factors in fulfilling their duty to promote the success of the company, ensure that the intermediation costs associated with a publicly traded company are minimised, ensure that corporate reporting is focused on forward looking strategy and not allow expectations of market reaction to short-term performance metrics to significantly influence company strategy (see Appendix C).

3. The role of Asset Managers

The starting point when considering the role of asset managers, or fund managers, is that the UK asset management industry is fragmented and portfolios typically contain many stocks. The business models of asset managers depend on their *relative* performance. Asset managers compete to outperform each other, but such outperformance is gained largely at the expense of each other. These factors reduce incentives for constructive engagement with investee companies. The Review recommends that this problem be addressed in two ways:

- Expanding the opportunities for collective action by asset managers,
- Encouraging a market structure in which asset managers' portfolios earn returns by enhancing the performance of the underlying investments.

The need for collective action should be addressed, according to the Review, by the establishment of an investors' forum which aims to facilitate action on issues of concern to investors in general and in relation to particular companies. This is the Kay Review's fourth recommendation (see Appendix B):

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

The Review suggests that such a body should have its own distinctive voice, independent of government and companies, which can strongly advocate the position of savers to those companies in which they have an economic interest.

One concern about the investors' forum, noted in the interim report of the Kay Review (2012b), is that fund managers were concerned by legal or regulatory restrictions on collective action, and particularly by the concert party rules of the U.K. Takeover Panel. These rules require a group of shareholders acting in concert who hold more than 30% of a company to make a bid for the whole company. The Review team were assured by the Panel that this rule is not intended to restrict the ability of major shareholders or asset managers to act together to improve company performance.

Another concern of asset managers is that insider dealing rules inhibit engagement with companies. Insider trading has been illegal in the U.K. since 1980, though the Financial Services Authority only gained criminal prosecution powers in 2001, and the first successful prosecution was not secured until 2009. Enforcement proceedings in the U.S. have also become more frequent, notably with the recent prosecution of the Galleon hedge fund manager Raj Rajaratnam, who in 2011 was handed the longest ever U.S. prison term for such crimes of 11 years [Lattman, 2011].

Insider trading of price sensitive information in breach of fiduciary duty is a serious crime and effective regulation of insider trading has an important role to play in ensuring confidence in financial markets. The Review notes, however, that there is a potential inconsistency in advocating more effective engagement between companies and investors, and at the same time prohibiting investors from deriving financial advantage from such engagement beyond the limited extent that such engagement benefits all shareholders. There is a need to ensure that the twin objectives of increasing shareholder engagement and deterring market abuse remain aligned.

A key hindrance to effective find management is that performance is judged on short time horizons. The asset manager who (correctly) believes he has a better understanding of the fundamental value of a company must expect to incur regular underperformance during quarterly reporting periods until the unpredictable time at which the mispricing is corrected. Excessive frequency of reporting of investment performance is not only damaging to the broad goal of better stewardship but also to the long-term interests of savers. This has led to the Kay Review's eleventh recommendation (see Appendix B) that mandatory quarterly reporting obligations should be removed.

The Review recommends, inter alia, that asset managers should hold more concentrated portfolios, have less need for liquidity, place less emphasis on short term relative performance, and develop closer relationships with investee companies (see Appendix D). The discussion of good practice in asset management ends with a description of the methods followed by Warren Buffett:

- selection of a comparatively small portfolio of businesses, based primarily on the characteristics of the company rather than the cheapness of the stock,
- very long holding periods,
- stakes in the company of sufficient size to be capable of a (rarely exercised) influence on management succession and strategy.

Two other features of Buffett's approach are also highlighted:

- there is near complete alignment of the interests of savers and fund manager, since Buffett is rewarded almost entirely by the increasing value of his own holding in the fund, Berkshire Hathaway,
- because the fund is a listed closed ended security, where savers hold shares in the fund company rather than units in the fund, there is liquidity for savers even although there is little or no liquidity in many of the holdings within the fund. The closed-ended investment company model also means that fund managers can take a long-term view: they are not obliged to buy or sell shares in companies they hold in unfavourable market conditions in response to savers buying or selling the fund.

Noting the success of Berkshire Hathaway, the Review recommends that Buffett's strategy represents a good starting point for any discussion of good practice in asset management.

4. The role of Asset Holders

Asset holders have a duty to their savers, which they should manage to fiduciary standards. They will meet these obligations best by establishing relationships with fund managers in whom they have trust and confidence, and reviewing these relationships at intervals of no less than three to five years, emphasising *absolute* returns irrespective of whether the asset manager's mandate is general or specialist.

Relative performance may be defined as performance relative to a benchmark index or to other funds pursuing similar asset classes or investment strategies, whereas absolute performance is the total return generated by a fund or portfolio. The interests of beneficiaries are largely based on long-term absolute performance, whereas the concern of asset managers – and the basis on which they are monitored by many asset holders – is short term relative performance. The Review notes that this misalignment of incentives creates many problems.

Competition between asset managers to outperform each other by anticipating the changing whims of market sentiment can add nothing, in aggregate, to the value of companies. The Review makes an allusion to Keynes' beauty contest, after a famous passage in his [Keynes, 1936] *General theory of Employment Interest and Money*. Keynes was referring to contests popular in the U.K. at the time where a newspaper would print 100 photographs, and people would write in picking the six faces they liked most. Those who picked the most popular face was automatically entered in a raffle to win a prize. Keynes [Keynes, 1936] wrote:

> *"It is not a case of choosing those [faces] which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees."*

Any positive impact on company performance and overall returns to savers must come, argues the Review, through investment research which aims to understand the activities of the company and from direct engagement with the company itself. Analysis of the fundamentals of a company has no direct impact on the underlying value of a company (just as observing which face is most beautiful has no direct impact on the attractiveness of the faces). But fundamental analysis has an indirect effect, which may be very large, in enabling companies to make long-term decisions with greater confidence that the benefits of such decisions will be recognised by investors.

One issue deterring effective engagement is the 'free rider' problem [Grossman and Hart, 1980]. Those who undertake engagement with companies must devote resources to it, while their share of the benefits reflects only the proportion of the shares which they own. Thus most of the benefits of engagement are derived by other shareholders. Engagement thus has the character of a public good as most of the benefits accrue to those who do not get involved. Even if the benefits of analysis and engagement are large, the incentives for any individual fund manager to pursue these benefits are weak, since most of the additional return will accrue to non-clients and most of the business benefits will accrue to other firms.

Client money is often invested by asset managers in funds that follow a particular asset management 'style' (such as value funds or growth funds). Selection of the style that is likely to make money should be a decision on which the asset manager is judged. The Review makes the pertinent point that "in the long run, a good manager of bad assets is a bad manager" [Kay Review, 2012, p. 52]. It advocates that asset holders who place funds with more than one manager should seek to achieve diversification of asset management styles. This is not the same as the practice of asset allocation to standard benchmark categories since the globalisation of product and capital markets has resulted in correlations between these benchmark categories being often high.

The Review recommends, inter alia, that asset holders should set mandates which focus managers on achieving absolute returns in line with beneficiaries long-term investment objectives, rather than short-term relative performance benchmarks; recognise that diversification is the result of diversity of investment styles; review performance no more frequently than is necessary, and with reference to long-term absolute performance; and encourage and empower asset managers to engage with investee companies as a means of improving company performance to deliver investment returns (see Appendix E).

Conclusions

Governments of all political persuasion are arguably good at commissioning independent reports and then ignoring their contents. By so doing they show concern about a particular issue and imply that they would like to change things for the better without actually doing anything [Hilton, 2012]. However in its response to the Kay Review, the U.K. Government has indicated not only that it agrees with almost all of the recommendations but that it will use its influence to implement them. Whether the U.K. Government is able to deliver on these fine words remains to be seen.

There are some issues where no immediate action need be taken. For example, the concern about quarterly reporting acting as a barrier to long-term thinking will likely be resolved by moves already under way in the European Union to reform reporting practices. A more contentious issue is the observation that the U.K. Government should take a much greater interest in takeovers, and whether any specific deal should be welcomed or not. Although the most high profile takeover deals have typically involved foreign companies buying U.K. firms, the concern about short-termism also applies to U.K. firms that prefer growth by acquisition to organic growth. The idea that listening to customers, investing in the business and growing market share – rather than buying and selling businesses within the group – is the way to create value may well prove to be a difficult idea to sell to current U.K. boards. On the other hand, Kay's recommendation for a new investors' forum that could act as a clearing house for shareholder concerns, and a channel through which they could engage with companies on serious issues, looks likely to be implemented, given early indications that the investment industry is actively consulting on the matter.

Ultimately there is no single policy initiative that is going to achieve greater engagement by investors with companies and a greater willingness to think in the long term. The government itself cannot solve the problem. What is required is a major shift in culture among the investment community, which has to accept the need to reform itself and move towards a more responsible ownership model. The likelihood of this happening soon should not be overestimated.

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Responsible Capitalism and the Culture of Investment (Summary)

This paper outlines the background to, and describes the main conclusions of, the government-initiated *Kay Review* into UK equity markets and long-term decision making published in July 2012. The review, whose conclusions were accepted by the UK government, vividly describes flaws in the relationships between investors and businesses and concludes that short-termism is a key problem. It suggests that the principal causes of the short-term approach to investment are a decline of trust and the misalignment of incentives at the various stages of the equity investment chain. Among its recommendations is that the *UK Stewardship Code*, which advocates greater engagement by shareholders with the companies in which they invest, should include a more expansive form of stewardship, focussing on strategic as well as corporate governance issues.

Keywords
corporate governance, agency theory, stewardship, institutional investors

Appendix A
Principles for Equity Markets

1. All participants in the equity investment chain should act according to the principles of stewardship, based on respect for those whose funds are invested or managed, and trust in those by whom the funds are invested or managed.
2. Relationships based on trust and respect are everywhere more effective than trading transactions between anonymous agents in promoting high performance of companies and securing good returns to savers taken as a whole.
3. Asset managers can contribute more to the performance of British business (and in consequence to overall returns to their savers) through greater involvement with the companies in which they invest.
4. Company directors are stewards of the assets and operations of their business. The duties of company directors are to the company, not its share price, and companies should aim to develop relationships with investors, rather than with 'the market'.
5. All participants in the equity investment chain should act in good faith, in the best long-term interests of their clients or beneficiaries, and in line with generally prevailing standards of decent behaviour. This means ensuring that the direct and indirect costs of services provided are reasonable and disclosed, and that conflicts of interest are avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary. These obligations should be independent of the classification of the client and should not be contractually overridden.
6. At each stage of the equity investment chain, reporting of performance should be clear, relevant, timely, related closely to the needs of users and directed to the creation of long-term value in the companies in which savers' funds are invested.
7. Metrics and models used in the equity investment chain should give information directly relevant to the creation of long-term value in companies and good risk adjusted long-term returns to savers.
8. Risk in the equity investment chain is the failure of companies to meet the reasonable expectations of their stakeholders or the failure of investments to meet the reasonable expectations of savers. Risk is not

short-term volatility of return, or tracking error relative to an index benchmark, and the use of measures and models which rely on such metrics should be discouraged.

9. Market incentives should enable and encourage companies, savers and intermediaries to adopt investment approaches which achieve long-term returns by supporting and challenging corporate decisions in pursuit of long-term value.
10. The regulatory framework should enable and encourage companies, savers and intermediaries to adopt such investment approaches.

Appendix B
Kay Review Recommendations

1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.
2. Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should takes steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements.
3. An investors' forum should be established to facilitate collective engagement by investors in UK companies.
4. The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves.
5. Companies should consult their major long-term investors over major board appointments.
6. Companies should seek to disengage from the process of managing short term earnings expectations and announcements.
7. Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.
8. Asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund.

9. The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers.
10. All income from stock lending should be disclosed and rebated to investors.
11. Mandatory IMS (quarterly reporting) obligations should be removed.
12. High quality, succinct narrative reporting should be strongly encouraged.
13. The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations.
14. Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment.
15. Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business.
16. Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund.
17. The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.

Appendix C
Good Practice Statement for Company Directors

Company Directors should…

1) understand their duties as directors under the Companies Act 2006, and in particular acknowledge the relevance of considering long-term factors, including relevant environmental, social and governance issues, and the reputation of the company for high standards of business conduct, in fulfilling their duty to promote the success of the company;
2) acknowledge that long-term value creation in the interests of shareholders is best served by strategies which focus on investing appropriate-

ly to deliver sustainable performance rather than treating the business as a portfolio of financial interests;
3) act to ensure that the intermediation costs associated with a publicly traded company are kept to a minimum;
4) ensure that corporate reporting is includes a focus on forward looking strategy;
5) facilitate engagement with shareholders, and in particular institutional shareholders such as asset managers and asset holders, based on open and ongoing dialogue about their long-term concerns and investment objectives;
6) provide information, in the context of corporate reporting and ongoing shareholder engagement, which supports shareholders' understanding of company strategy and likely long-term creation of value, including by agreeing a range of performance metrics relevant to the company;
7) communicate information to shareholders which aids understanding of the future prospects of the company, even if this means going beyond (but not against) the strict requirements of accounting standards, for example on market valuations;
8) not allow expectations of market reaction to particular short-term performance metrics to significantly influence company strategy;
9) refrain from publishing or highlighting inappropriate metrics which may give a misleading impression of anticipated future company performance;
10) be paid in a way which incentivises sustainable long-term business performance: long-term performance incentives should be provided in the form of company shares to be held until after the executive has retired from the business;
11) consult their major long-term investors over major board appointments (Recommendation 5 of the Kay Report);
12) seek to disengage from the process of managing short-term earnings expectations and announcements (Recommendation 6 of the Kay Report).

Appendix D
Good Practice Statement for Asset Managers

Asset Managers should…

1) recognise that they are in a position of trust managing client money and should act at all times in the best long-term interests of their

clients, informing them of possible conflicts of interest and avoiding these wherever possible;

2) operate within a culture of open dialogue with their clients – building an agreed understanding of investment objectives and risks, which is informed by their investment expertise;
3) provide information to clients, including information on investment performance, in a way which is clear, timely, useable and relevant to the long-term creation of value in the investee companies, and therefore to clients' investment objectives;
4) disclose fully all costs that fall on investors in a way that investors can understand;
5) ensure that income generated from lending securities is rebated in full to the fund, with any related costs disclosed separately;
6) adhere to the investment strategy agreed with clients;
7) prioritise medium to long-term value creation and absolute returns rather than short-term returns from market movements when making investment decisions;
8) build an ongoing relationship of stewardship with the companies in which they invest to help improve long-term performance – recognising that engagement goes beyond merely voting;
9) make investment decisions based on judgments about long-term company performance, informed by an understanding of company strategy and a range of information relevant to the specific company (including relevant environmental, social and governance issues), and avoiding reliance on single measures of performance;
10) be prepared to act collectively to improve the performance of their investee companies;
11) be paid in line with the interests and timescales of their clients. Specifically remuneration should not be related to short-term performance of the investment fund or the performance of the asset management firm. Instead, a long-term performance incentive should be provided in the form of an interest in the fund (directly or via the firm) to be held until the manager is no longer responsible for that fund.

Appendix E
Good Practice Statement for Asset Holders

Asset Holders should…

1) recognise that they are in a position of trust managing client money and should act at all times in the best long-term interests of their

clients, informing them of possible conflicts of interest and avoiding these wherever possible;

2) operate within a culture of open dialogue with beneficiaries – building an agreed understanding of investment objectives and risks;
3) provide information to beneficiaries, including information on investment performance, in a way which is clear, timely, useable and relevant to clients' investment objectives;
4) be proactive in setting mandates for asset managers based on open dialogue about agreed investment objectives;
5) set mandates which focus managers on achieving absolute returns in line with beneficiaries long-term investment objectives, rather than short-term relative performance benchmarks;
6) recognise that diversification is the result of diversity of investment styles;
7) review performance no more frequently than is necessary, and with reference to long-term absolute performance;
8) encourage and empower asset managers to engage with investee companies as a means of improving company performance to deliver investment returns.