**The Hundred Group**
of Finance Directors

**Investor Relations and Markets Committee**

Website submission: kayreview@bis.gsi.gov.uk

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

18 November 2011

Dear Sir

**Call for Evidence – The Kay Review of UK Equity Markets and Long Term Decision Making**

We previously responded to the Government's call for evidence on a long term focus for corporate Britain. We support the Government's view that further action is required in this area and are pleased to contribute further to this debate.

The views expressed in this letter are based on our experiences as company Directors. We recognise that investors and stakeholders are better placed to comment on many of the questions posed and consequently we have limited our responses to those areas most relevant to companies.

**Who we are**

The Hundred Group represents the views of the Chief Financial Officers of FTSE 100 index constituents and several large UK private companies. Our Members collectively employ over 1.6 million people in the UK, and pay, or collect 12% of the UK Exchequer's overall tax take. We seek to assist the development of UK businesses particularly in the areas of tax, reporting, pensions, regulation, capital markets and corporate governance.

**Our views**

We share the Government's view that successful companies, and the markets in which they raise capital, are vital to the health of the UK economy. In the current economic environment the importance of flexible and liquid capital markets cannot be underestimated: public equity has been a significant source of finance for UK corporates, because of the comparative ease of access to that financing, particularly when credit markets are in flux. That availability was important to a number of companies through the recent recession.

The survival of companies depends both on long-term strategies that permit fluctuations in performance in the near term, but also on short-term flexibility which can help protect cashflows and respond to market volatility. In our opinion this is precisely the balanced relationship that our markets, and investors, should reflect.

Over recent years, access to the equity markets has come more easily and at lower cost. In turn that has encouraged some types of short-term behaviour. On balance we applaud greater equity market access and the depth of liquidity which accompanies it. However, we also believe that it would be appropriate for the Government to review incentives for long-term investment and other changes that would support value creation over longer than the short term. However, we would not support any changes which would increase the costs of short-term investment and consequently increase barriers to investment.

Over time, there has been a long term trend of reducing share ownership by UK institutions. This is in part due to trends in defined benefit pension schemes, themselves caused in large part by successive government's appetite for amendments to pensions legislation but also from other factors which are set out in our detailed response. There has also been a trend towards an increasing proportion of investment in UK equities coming from non UK institutions. Whilst the UK stewardship code has shown signs of being successful in the UK, it does not have international reach and non UK institutions may not be overly concerned with its provisions. Concerted action on an international level is the only remedy in this regard.

Where the Government does have a role to play is in setting out its vision of a long term regulatory and fiscal framework. Business needs a level of certainty to make investment decisions and a lack of clarity on future investment returns, together with a recent history of surprise changes in regulation which in our view have been more geared to short term political gain, have created a level of uncertainty which is unhelpful in promoting the long term interests of corporate Britain. We set out specific examples in our detailed responses.

We accept that on some issues, the Government is obliged to implement the regulatory framework determined in Brussels and amongst our most significant concerns going forward are the European proposals to levy a tax on financial transactions and to implement a solvency type regime on defined benefit pension schemes. In respect of the former, we agree with the Government that unless this is implemented on a global basis, the damage it will do to London as a financial centre, and therefore on the wider UK economy, will be considerable. In our view, the latter will further exacerbate the trend seen over recent years for pension funds (traditionally long term holders of equity) to switch into longer dated bonds to mitigate the risk of transient market fluctuations.

In our response, we have stressed the importance of action taken on an international basis. We do not advocate, not would we support, any measures that are taken to address any concerns over short termism in the UK which would inevitably have the effect of damaging the UK's competitive advantage. The world is becoming much more international and businesses in the UK have got to have flexibility to compete on an even playing field at a time when information is more quickly available, new businesses have choices over where to set up their operations and education standards are rising in several low cost countries.

Please feel free to contact me if you wish to discuss the views contained within this letter.

Yours sincerely

**Robin Freestone**
*Chairman*
*Hundred Group: Investor Relations and Markets Committee*

**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.**

As directors responsible for leading the UK's largest Companies, it is vital that we have long term strategies for value creation, development and growth. Indeed it is the role of an effective board to be collectively responsible for the long-term success of the company, under both the Companies Act and other regulations.

To carry out their responsibilities effectively, boards meet regularly to consider the future strategic direction of their businesses, including the development of risk assessments and mitigating actions and sensitivities over possible future outcomes. Forming a view on future strategy is not possible unless the Board considers the longer term. However, it may sometimes be the case that decisions necessary to ensure progress towards longer term strategic objectives are not always beneficial in the short term. In these instances, it is important that the Board and the Company's shareholders are appropriately engaged so that there is a shared understanding that the short term earnings impacts will be more than offset by the potential of longer term returns in order that the company's share price is not unduly affected.

The underlying beneficiaries of value creation activities will principally be the Company's shareholders, but also the Company's employees and, less directly, other stakeholders. It is not possible to generalise as to the time horizon over which these groups make decisions as their motivations may differ. However we note the following as relevant considerations:

It is not always possible to identify who the beneficial owner of a Company's equity is. In the UK, we are able to use our rights under s793 of the Companies Act 2006 to obtain information on the identity of our shareholders. As responsible management we routinely engage with key shareholders on future strategy and overall governance. Outside of the UK, however, the ability to identify shareholders is not assisted by legal rights and consequently it is not always possible to ensure full engagement.

We have observed a recent trend towards more short term investment by professional "day traders", "prop desks" and some hedge funds of a "long/ short" nature, some using algorithmic trading approaches. Some of these investors trade the market, not through the equity itself, but through synthetic derivative products including "contracts for difference," which are often used because they do not attract stamp duty. Not only does this also present challenges for shareholder identification, it also tends to reinforce short term movements in share price which exacerbate market shocks.

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

There is no doubt that changes to the market place over recent years have encouraged short-termism, including a reduction in costs and improvements in technology which have improved access to equity markets. This trend is, however, an international one and it would be to the UK's disadvantage if regulatory changes were made to the functioning of the UK markets which would unduly impact on the UK's ability to attract and retain investment.

We strongly support an open market and counter suggestions that that only long-term behaviour is beneficial to companies. Whilst long-term behaviour is undoubtedly helpful and more likely to be aligned to the strategy of the company and the board, short-term behaviour can also provide vital flexibility and agility when needed. The fact that most UK companies

weathered the recent financial crisis so well is in part due to their ability to raise funds on the market in relatively short order.

We are, however, concerned over the growing trend towards algorithmic trading in equity; through "contracts for difference" and other short term methods. These, and other short term instruments, have the ability to significantly exacerbate market shocks. In today's world of instantaneous transmission of information, shocks are reported in the media on an almost real time basis and with market confidence so important in ensuring economic stability, the effect of such news becomes largely self fulfilling. We note recent research which indicates that over the summer of 2011, there were nine separate occasions when the FTSE 100 rose by more than 2% in a single trading day and 12 one-day falls of more than 2%. This compares to the longer term average of the FTSE 100 where between 1984 and the summer of 2011, the index rose by more than 2% just two days a quarter. Falls of a similar size also averaged about two a quarter.

In our experience, to plan over the longer term, the Board needs sufficient confidence that the strategic decisions they are making will deliver shareholder value. In that sense, the functioning of the equity markets in contributing to market sentiment does impact on the Board's long term decision making.

**Whether Government policies directly relevant to individual quoted companies (such as regulation and procurement) sufficiently encourage boards to focus on the long term development of their businesses.**

Business needs a level of certainty to be able to consider longer term decisions. In considering investment opportunities, the inability to predict the longer term regulatory and fiscal framework, not to mention the incentives available to invest, will significantly increase the risk associated with any decision. An often quoted example is the appetite for investment in the Far East. Even 10 years ago, many UK companies were hesitant to invest significant sums in Far Eastern economies such as China because of the uncertainty associated with investment returns over the longer term. A combination of local government policy, investment incentives and confidence in the macroeconomic environment over time has led to a complete reversal such that China is now one of the most inwardly invested countries in the world by UK and other western companies.

We are very concerned that the UK government is taking too long to set out its vision of a long term regulatory framework, and where it has, actions taken for short term political gain do not back up the promises made. This point can be well illustrated by our Members recent experience of pensions legislation.

Until the mid-1980s, there was relatively little prescription relating to the benefits provided by defined benefit pension schemes – employers provided features such as increases in payment on a purely discretionary basis as and when investment returns made such increases possible. Since then, a succession of legislative measures has substantially raised the minimum requirements for existing pension benefits, thereby imposing costs on employers that they had never envisaged when they introduced their defined benefit schemes. These include stronger preservation requirements, requirements for guaranteed revaluation in deferment and indexation in payment and the ramping up of the amount of section 75 debt payable when an employer exits a scheme to the cost of buying out benefits with an insurer.

Overall, successive governments have failed to provide a stable legislative framework for defined benefit pension schemes. We have seen Pensions Acts in 1995, 2004, 2007, 2008 and now 2011 with the Pensions Act 2004 effectively replacing all the main provisions of the Pensions Act 1995 (in particular with the Pensions Regulator replacing OPRA and scheme

funding replacing the MFR, and with the introduction of the Pension Protection Fund). There has been a similar lack of stability in relation to pensions taxation, with the complete rewrite of tax law at April 2006 being largely rewritten only 5 years later with the reduction of the annual allowance to £50,000 (and with numerous smaller legislative tweaks every year in between). The number of statutory instruments relating to pensions is staggering, with over 100 in 2005 alone. Simply keeping up to date with these legislative changes leaves employers facing sizeable compliance and advice costs, in addition to the actual costs of the changes themselves.

These changes have contributed to an increasing trend for UK institutions (particularly pension funds) to withdraw from equities and switch investment into lower risk bonds such as Gilts. This has the impact not only of removing important market participants who typically hold equities for the long term, but also driving down the rate of return on bonds. Since pension liabilities are typically discounted using the risk free bond rate, lowering the rate of return serves to increase the present value of a pension scheme's liabilities with the consequent impact on sponsor companies having to devote an increased level of cash and other resource to making good the increased deficit – funds which might otherwise be used for investment, growth or job creation in the private sector. This trend will be accelerated under European Union proposals to introduce a solvency type regime for defined benefit pension schemes in a misguided attempt at harmonising pensions regulation across European borders. Given the nature of retirement provision across Europe, it appears likely that the UK will be one of the few countries to be impacted by these proposals and we strongly urge the Government to resist any changes to this regime which will challenge long term equity investment by UK institutions even further.

We also reference the following examples:

- Reform of controlled foreign companies regulations. In our response to this consultation, we supported the overall aims of the reforms but were concerned that the detailed drafting resulted in a more complex regime which did not support the overall objective of reform;

- The surprise imposition of a 12% incremental tax on the profits of North Sea Oil producers in the 2011 budget;

- The findings of the independent commission on banking which if implemented would leave little incentive for UK corporate depositors to retain their deposits with UK banks during times of economic difficulty or wholesale bank funding stress.

We are also concerned that the Government fails to appreciate the contribution of large companies to the UK growth agenda: analysis indicates that large companies grow productively eight times faster than smaller ones. At this time of economic uncertainty it is more important than ever that government creates the right environment, both from a fiscal and regulatory perspective to allow UK business to flourish.

Finally, one feature of the recent financial crisis was a failure to understand the risk associated with too high levels of leverage. This had both liquidity and solvency implications over the longer term and not just for banks. Good management teams did not succumb to the short term mantra of leverage as a panacea, notwithstanding the tax efficient nature of debt compared with equity. However for those who did, there was little protection for long term shareholders who saw significant equity returned to owners, above what was sensible, usually in the form of share buy backs or very low equity capital injections in the first instance (often at the point of a buy out). Controls in this area remain very weak with little protection, other than the ancient and invalid UK Companies Act concept of distributable reserves. We do not favour a mandatory gearing test. It would be too complex, in particular because different thresholds would be needed for different sectors. However some form of increased

disclosure, risk reporting and going concern stringency when gearing is high might be considered.

**The quality of engagement between institutional investors and fund managers and UK quoted companies, and the importance attached to such engagement, building on the success of the Stewardship Code.**

**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.**

We fully support an open and transparent relationship with our shareholders and indeed regular engagement is one of the key aspects of good governance. The commitment our members have to this engagement and to clear communication with shareholders is evidenced by the amount of resource dedicated to investor relations. In our experience, clear, relevant and timely communication with investors improves investment decisions and boosts investor confidence.

The UK stewardship code is still relatively new and as time goes by we see positive effects on shareholder engagement, however the full benefit needs more time to be fully felt. The stewardship code does of course reinforce the point that UK regulation can only impact UK investors and consequently we are supportive of similar codes being adopted internationally, reflecting the diverse nature of our shareholder base – non UK institutions may not concern themselves overly with the UK code's guidelines.

We have already noted a concern over the ability to identify the ultimate beneficiary of share ownership. This is particularly pertinent as the level of international investment grows as a source of funds to UK business. This trend is only likely to increase as many developing economies open up their investment funds to equity ownership opportunities outside their home countries. Faced with this trend, we would encourage the Government to take the lead in establishing an international framework which would support disclosure of ownership at similar thresholds to the current UK requirements.

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

We support the Government's view that growing overseas investment has had a positive impact on UK business and supported growth in the UK economy. In particular we welcome and encourage such investment and would be opposed to any restrictions which would impede cross-border investment.

In particular we are very concerned about proposals emanating from the European Union which in our view would damage the reputation of the UK as a centre for inward investment. In particular:

- The proposed financial transaction tax
- The draft proposals on the regulation of the external audit market

We are currently supporting Government initiatives aimed at mitigating the impact of these proposals on the UK market and will continue to do so.