The Kay Review of UK Equity Markets and Long-Term Decision Making
Aviva Investor's response to the Call for Evidence (Nov 2011)

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.

1.1 The time horizons of asset managers can vary considerably depending on the type of fund, mandate and individual's own 'experience'. As a largely long-term, risk averse equity investor, we are investing for our clients for the long-term. Looking at the broader dynamic in the capital markets, however, the pressures are clearly to the short term, which ultimately affects both investor and company behaviour. Our answer to this question seeks to confirm our perceptions of this as investors and to provide context for the more specific issues we touch on in the answers to subsequent questions.

1.2 In committing client capital to (listed) businesses we are interested in the long-term view of the prospects and growth of those companies, within the constraints established by the mandates we have to operate within (e.g. on portfolio construction, such as market cap weighted benchmarks and the risk budgets or tracking error restrictions allocated to funds), which we touch on further in our answer to Q.6.

1.3 An interest in and assessment of strategy, competitive positioning, operational efficiency and the leadership of businesses, clearly form part of the active investment process and approach we deem necessary for long-term investment. We also seek to identify stocks which are under priced by the market and/or offer a strong (risk weighted) yield and buy them in the expectation that over time the return will be greater than that of the market as a whole. It's notable in that context that, of the main active styles, 'value' and SRI style managers tend to have lower turnover in their portfolios (see our answer to Q.9). We discuss aspects of the countervailing dynamic in the broader capital markets and corporate dynamic in our answer to Q.3.

1.4 Passively managed (index replication) funds will reflect the stock market index, usually with a bias to larger companies (reflecting the market cap weighting of traditional indices) and companies will be held when and for as long as they are in the index. Such index replication portfolios not only seek to minimize fees and costs, but are increasingly being used for other investment types, including bonds and commodities.

1.5 That said, looking at the dynamic more broadly, in May of this year the Bank of England's Andrew Haldane and Richard Davies highlighted[1] that the discount rates being applied to future cash flows were too high and that was having an adverse impact on peoples' investment choices and time horizons; a phenomenon they termed "capital market myopia". This concern is also shared by counterparts in the US.[2]

1.6 From an investor's perspective, this is neither revolutionary nor novel and is certainly an issue that is apparent in the capital markets. Academics have been highlighting the problem for some time from their testing of the notions of market efficiency, rational expectations and specific capital asset pricing models.[3] Not least they found those notions fail when tested against the particular alternative of short-termism, in the form of excessive discounting of future returns. It is notable then that, even though corporate and financial practitioners shared this view well before the crisis, little changed.[4] So we are not surprised that these issues have been drawn together post the crisis and welcome the debate about the role that long-term investors should play in terms of stability, enabling corporations to focus on long-term strategic decisions and supporting economic growth. This must be significant if good long-term corporate investment opportunities (requiring a higher initial capital investment) that have a lower IRR (expected return), but a higher

1 "The Short Long", speech by A.Haldane and R.Davies, Bank of England
2 "Lessons from the Financial Crisis: The dangers of Short Termism" S.Blair, Chairman of the FDIC
3 See for example: "Testing for short-termism in the UK Stock market: A reply", (1995) D. Miles, or "The Behaviour of UK Stock Prices and Returns: Is the Market Efficient?" (1997) Cuthbertson *et al*
4 See for example the CFA & Business Roundtable Symposium Report "Breaking the Short-Term Cycle" (2006), or the survey of over 400 financial executives "The Economic Implications of Corporate Financial Reporting" (2005) by Graham et al..

NPV (increase in shareholders' wealth), are being passed up for faster and less value added alternatives.

1.7 The practical issues for long-term investors and investment of liability profiles, risk appetite and the decision making structures of different classes of investor have been examined in detail elsewhere.[5] However, underlying those issues and the trends being seen in asset allocation (see our answer to Q.10), the issues of myopia and short-termism are distinct ones on which we share the concerns that have been raised.[6] This is apparent not only in the market's increasing focus on short term (high frequency) trading and in what we see in terms of the broader level of portfolio turnover and falling holding periods (see answer to Q.9), but also in the incentives of both market participants and corporate managers.

1.8 Recent years also seen considerable growth in alternative shorter term strategies, for example, hedge funds, that often focus on short-term developments and trends. We discuss this, in terms of high frequency trading ("HFT"), in our answer to Q.2.

1.9 As a general observation, investors,[7] like corporate managers,[8] are subject to behavioural biases and reforms that just target structural aspects of governance and regulation, without recognising the behavioural issues that can exist, may not have the desired effect.[9] Dynamics such as short corporate reporting cycles/milestones and short-term performance measurement of investment portfolios are factors that both feed off and contribute to the short-term orientation of the capital markets and, in some cases, the behaviour of companies (we touch on this further in our answer to question 3).

1.10 As long-term investors, one of the puzzles of the sluggish global economy today is why companies aren't investing more. As a recent McKinsey survey[10] noted, companies certainly seem to have good reasons to invest: corporate coffers are full, interest rates are low, and a slack economy inevitably offers bargains. Yet many companies seem to be holding back. Although market volatility, concerns about the risks of a double-dip recession and ongoing uncertainty around economic policy all play a role in this, one factor that the authors were at pains to highlight was the surprisingly strong role of behavioural biases in the corporate investment decision-making process.

1.11 Their survey found that most executives believed that their companies were too loss averse in their approach, particularly where investments would be expensed immediately through the income statement and not capitalized over the longer term (we touch on accounting issues further in our response to Q.5). Two-thirds of the respondents indicated that their companies underinvested in product development[11], and more than half that they underinvested in sales and marketing and in the financing of start-ups for new products or new markets. This should be of significant interest to policymakers as, as the authors note, these aren't just a missed opportunity for individual companies: the investment dearth hurts whole economies and job creation efforts as well. To blame this all on the capital markets, however, would be unreasonable; they are one piece of the jigsaw.

1.12 We do not believe that there is a silver bullet that will address the issues that exist, rather a range of measures and reforms will be needed to be developed to change the economics of the various parts of the dynamic that exists and the incentives and accountability of participants at each step of the increasingly complex chain of intermediaries and surrounding market participants. This view has led us to scope and commission a number of pieces of work on the role and nature of

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5 See for example, "The Future of Long-term Investing" (2011), World Economic Forum & Oliver Wyman
6 See for example, "Short-Termism, The Financial Crisis and Corporate Governance" (2011) L.Dallas
7 See for example, "Seven Sins of Fund Management – A behavioural critique" (2005) James Montier, Dresdner Kleinwort Wasserstein
8 See for example, "CEO narcissism like the two faces of Janus" (2011) Chabuel & Desmartin, Oddo Securities
9 "Financial Regulation, Behavioural Finance and the Global Financial Crisis: In Search of a New Orthodoxy" (2009) E. Avgouleas
10 "A bias against investment?" (2011), Kholler et al, McKinsey Quarterly
11 In this context see: "Innovation and Performance in British-based Manufacturing Industries – a Policy Analysis" (2002) Cox and Frenz

capital markets in the future, the nature and incentives across the investment chain and, from an asset management perspective, how standard practices around transparency and accountability to clients can be enhanced, which we refer to later in this submission.

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

2.1 Building on our response to Q.1, although it would be possible to consider textbook examples of how individuals can and do assess companies and their competitive strengths, that would not offer a real insight into the variety of practice that exists, nor would it recognise the much wider dynamic that is at play in the capital markets. Amongst the issues that the review highlighted a particular interest in this context was the impact of technological advances and automated trading on investment. We believe that this dynamic and the developments that have been seen not only in the context of high frequency trading but also financial product development are particularly significant elements of the short-term orientation of the capital markets.

2.2 As the regulatory and standards frameworks, incentives and practice have all converged towards accommodating shorter time horizons, behaviours have normalised around and exacerbated that and the dynamic has become self-perpetuating, with increasing emphasis on immediacy and trading. This was neatly summed up by the founder of one US trading house who observed, in the context of the US flash crash, that "Over $1 trillion of market value evaporates in less than 15 minutes and people say, 'Who is to blame?'. No one is to blame. This is the market that we have. This is the by product of a market structure that has gone horribly wrong."[12]

2.3 To some extent it is hard to disagree with that sentiment. As long-term investors we share the view that market structure and dynamics are a problem that needs to be revisited in the context of the underlying role and purpose of the capital markets. We would like to think that the secondary markets served to support and facilitate the primary markets. However, it is hard not to feel that the relationship is being reversed.

2.4 As the McKinsey Global Institute has noted[13], for most of the first eight decades of the last century, financial assets (including equities, private and public debt and bank deposits) grew at about the same pace as GDP. However, after 1980 financial asset growth raced ahead, nearly quadrupling in size.

2.5 For the last 30 years, most of the overall increase in financial depth (ratio of assets to GDP) has been driven by rapid growth of financial instruments (incl. equities and private debt) in mature markets, although as of 2008 the crisis stopped that trend. Only a handful of economies, of which the UK is most notable, had a commensurate increase in 2008 (as a result the UK government bank recapitalization program and the related private debt issuance that more than offset the decline in equities). That said, at the same time cross border capital flows in the UK (2007/8) were negative $2.66trillion (~101% of GDP) as foreign investors withdrew more money from the UK than they put in. This is illustrative of the observations that can be made about the persistency of overseas capital (see our answer to Q.9).

2.6 Asset prices have both become more volatile and have moved in a series of alternating 'bull' and 'bear' market cycles that have been exacerbated by the increasingly technical (e.g. algorithmic) trading needed to exploit every possible asset pricing opportunity available. That dynamic has helped reinforced price trends, resulting in more extreme upward and downward price runs that last longer than counter-movements for extended periods of time. While some argue that spreads have reduced as a result of this activity, in reality the extent and depth of liquidity they really represent is questionable.

[12] "Speed-addicted traders dominate today's stock market" (2010) Los Angeles Times - http://www.themistrading.com/article_files/0000/0557/051610LosAngelesTimes.pdf
[13] "Global Capital Markets: Entering a New Era" (2009) McKinsey Global Institute

2.7 The recent financial crisis spilled over into the real economy mainly through the simultaneous devaluation of securities, housing and commodity wealth, with the severity of the crash magnified by the long upward trend in the preceding credit bubble and growth in speculative trading, which was facilitated and exacerbated by, amongst other things, pro-cyclical frameworks and standards and loose fiscal policies. This has helped feed trading in the capital markets, which have increasingly become more short-term orientated.

2.8 Looking back at the origins of high-frequency trading, after London moved from the trading floor to electronic trading in 1986, in what was known as the Big Bang, the average number of daily trades at the London Stock Exchange rose from around 20,000 trades to 839,244 and rising in 2007, with a peak in excess of 900,000, although the crisis has impacted that trend. That is just the on market equity volume and does not capture the full picture of related trading in, for example, contracts for differences (CFDs) and other related instruments. It is important, therefore, to recognize the range of parallel and connected trading strategies that exist and the fact that by 2007 Europe had become the most important region in the global derivatives market, with 44% of the global outstanding volume (significantly higher than its share in equities and bonds). Of that, the over-the-counter (OTC or off-market) element has largely been based in London.[14] According to the financial markets' research and strategic advisory firm, Tabb Group, increased competition, new regulation and exchange consolidation have set the stage for a new era in automated trading of equity options in Europe.[15]

2.9 Compared to estimates of 35% to 60% in the UK, in the US capital markets, it has been suggested that HFT can account for up to 56% to 75% of dollar trading volume in US equities.[16] The US Flash Crash in May 2010 was foreshadowed in the Black Monday crash of 1987. Computerised trading, high frequency traders and what is known as "order flow toxicity"[17], have been attributed with creating the biggest one-day point decline on an intraday basis in Dow Jones Industrial Average history.[18]

2.10 The literature on the impacts of speculation has been around for some time,[19] pointing to links between speculative trading and excessive price movements and continues in more recent work, which has again highlighted the spill-over between speculative activity on real investments and the creation of excessive volatility in prices.[20]

2.11 At a headline level a distinction needs to be drawn between those who mainly trade shares and those who commit material amounts of capital to companies through the markets. Proprietary and principle traders that buy or sell equities or substitute instruments, often with their own capital, including hedge funds and others with very high portfolio turnover, such as high frequency traders, tend to be driven by short- term market trends and turn over their portfolios rapidly. Those that invest will also buy and sell equities but tend to hold them for the long term based on their analysis of the prospects of the company and their perception of the underlying performance. That said, although asset managers should not have an incentive to trade equities, because the associated costs reduce investment performance, the range of practice varies considerably, as noted in our answer to Q.9.

2.12 While proponents of high-frequency trading argue that it provides liquidity to the market, there is evidence to the contrary.[21] Amongst other issues, not only is high-frequency trading positively

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14 "The Global Derivatives Market – An introduction" (2008) Deutsche Borse Group
15 "EU Equity Options Market Structure: Opening The Door To High Frequency Flow" (2011) Tabb Group
16 See for example: http://www.bloomberg.com/news/2011-10-05/with-high-speed-trading-market-cannot-hold-commentary-by-mark-buchanan.html or http://xtiburon.com/finance/how-high-frequency-trading-affects-the-market/
17 "The Microstructure of the 'Flash Crash': Flow Toxicity, Liquidity Crashes and the Probability of Informed Trading" (2011) Easley et al, *The Journal of Portfolio Management, Vol. 37, No. 2*
18 "Findings Regarding the Market Events of May 6, 2010" (Sept 2010), US SEC and CFTC
19 See for example, "Price Destabilizing Speculation" (1986) Hart & Kreps
20 See for example, "Trading Frenzies and Their Impact on Real Investment" (2011) Goldstein, Ozdenoren and Yuan
21 "High Frequency Trading, Stock Volatility and Price Discovery" (2010), F.Zhang, Yale School of Management

correlated to share price volatility,[22] which HFTs exploit aggressively, particularly for larger companies and those with high institutional holdings, but the general liquidity argument (clearly not borne out in the flash crash) is called into question. However, this must not be taken to mean that all short term investment activities are a problem, although valid concerns continue about the volume and impact of HFT.[23]

2.13 Academics from Cornell and Columbia Universities have highlighted the need to differentiate between the positive and negative elements that can accrue from short-time horizons. In their recently published research they highlight the positive role that arbitraging can play in making markets more efficient and eliminating mispricing. At the same time they highlight the risk that high frequency traders can create mispricing which is exploited to the disadvantage of ordinary investors.[24] It is also important to recognise the spill-over effects from trading in other 'markets' on the equity market.

2.14 We do therefore feel that steps need to be taken to curb the focus on and trends around HFT that seem to dominate the capital markets, although we are firmly opposed to the EU's proposed Financial Transaction Tax, which would be both damaging to long term risk averse investors and London, as well as ineffective in raising the (net) revenues envisaged (See Appendix 1). More broadly, this issues does form part of the wider, inherent or endogenous risks that financialization, the increase in speculation and decrease in investing, the growth of derivatives and use of leverage, the practice of shadow banking and lack of transparency, and institutions that are "too big to fail" all link together to create.[25] Although we do not plan to discuss shadow banking in this submission, this is a complex and important area that does merit consideration by the review.[26]

2.15 Linked to HFT, another related trend is that towards synthetic products. Although the issues arising around CDS and other instruments (e.g. CDOs which interact with them) have been subject to much debate and scrutiny subsequent to the crisis, other aspects of this broad trend (i.e. the extent to which ongoing financial market innovation and synthetic product development – arguably for speculative purposes - may affect capital allocation in and to the real economy or, indeed, dis-intermediate it), do need to recognised and, where appropriate, addressed.

2.16 In terms of product innovation crossing the line beyond the provision of any real utility, the Credit Default Swap (CDS) market saw outstanding amounts reach over $60 trillion in 2007 (or over 4 times the publicly traded corporate and mortgage US debt they were supposed to insure).[27] The proportion of the market that was 'naked' has variously been estimated at up to around 80%. While in aggregate that has raised concerns about both the potentially destabilising spill-over effects on real economy enterprises, as well as systemic issues around financial stability including from consequential counterparty risks, as is often the case the full scope of this market is complex.[28] CDSs are, for example, validly used to hedge unwanted credit exposure and enable investors, for example, to separate interest rate from credit risk or hedge systemic/industry-wide risk. A practical example would be to buy a sovereign CDS to hedge an investment in a Spanish company against the macro risks. Nevertheless, even separating out these kinds of activity, as Warren Buffett famously described them in 2003, derivatives bought speculatively are "financial weapons of mass destruction."

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[22] See also "An Empirical Study of Volatility and Trading Volume Dynamics Using High-Frequency Data" (2010) Lu and Lin; "High Frequency Traders, News and Volatility" (2011) Martinez and Rosu; and "Where is the Value in High Frequency Trading" (2011) Cartea and Penalva

[23] e.g. "High Frequency Trading: The growing Threat of Rogue Trading" (2011) Weber, London Business School

[24] "A Dysfunctional Role of High Frequency Trading in Electronic Markets" (2011), R. Jarrow and P.Protter

[25] See for example "Endogenous Risks and dangers to Market Stability" (2011) J.Pasztor

[26] See for example "Shadow Banking" (2010) Z.Pozsar or "The Financial Crisis of 2015 – An avoidable History" (2011) Oliver Wyman, amongst others

[27] See for example: "An Analysis of the Financial Crisis fo 2008: Causes and Solutions" (2008) A.Murphy

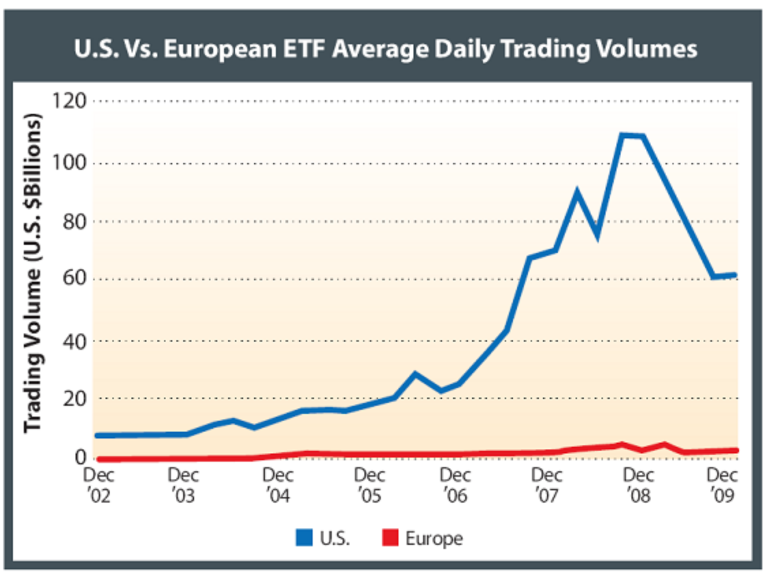
[28] See for example "Credit Default Swaps: So Dear to Us, So Dangerous" (2008) E.Dickinson or "The Promise and Perils of Credit Derivatives" (2007) Partnoy and Skeel

2.17 The trend towards the allocation of capital away from the real economy and the sometimes overriding focus of the capital markets and its institutions towards speculative trading and product innovation are an important facet of the growing tension that exists between the short-vs-long term challenges. As we have noted, this might be characterised as the secondary markets now feeding off rather than supporting the primary market.

2.18 A more current example of this dynamic is being seen in relation to Exchange Traded Funds (ETFs), which illustrate the links between product innovation, HFT and the economically significant ETF mispricing that can be seen reasonably frequently.[29] Amongst the many senior industry figures who have expressed their concerns about ETFs, John C. Bogle, founder of the Vanguard Group, has argued that ETFs are increasingly representative of short-term speculation and, as the trend moves away from plain vanilla ETFs, we are inclined to agree. He has also raised concerns about their trading expenses decreasing returns to investors, and the lack of adequate diversification. [30] As concerns have grown, even key players in the ETF market are acknowledging the need to change some of the practices that exist.[31]

2.19 As synthetic ETF production continues apace in Europe this can, amongst other things, be expected to play an increasingly important role in the existing short-term dynamics of the market and, by way of observation, we note that the SEC and CFTC found that ETFs made up 70% of all US-listed securities that plunged 60% or more during the Flash Crash.[32] It is also notable that the Financial Stability Board has recognised that "The recent rapid growth and innovation in the market for Exchange Traded Funds (ETFs) is a development that the FSB believes warrants increased attention by regulatory and supervisory authorities."[33]

2.20 In 2009 US ETF assets under management reached around $800billion (in Europe it was around $450billion), but the average daily trading volumes were extremely significant (see chart below), with ETFs regularly accounting for 30%+ of all dollar volume traded on US exchanges. While we don't have US data readily to hand, in addition to this the reported OTC value in Europe was an additional ~$650bn, so the total notional ETF trading in all European listed ETFs in 2009 was approximately~$1,500bn and the figure will be considerably higher in the US.



Sources: Factset, Bloomberg, Goldman Sachs. All data as of December 2009

29 "ETF Arbitrage" (2010) B.Marshall et al
30 See for example, http://www.terrysmithblog.com/straight-talking/2011/09/as-i-wrote-earlier-this-month-i-firmly-believe-that-etfs-are-being-mis-sold-to-the-retail-market-and-that-the-risks-that-are.html
31 "ETFs: A Call for Greater Transparency and Consistent Regulation" (2011) Blackrock, iShares
32 "Findings Regarding the Market Events of May 6, 2010" (Sept 2010), US SEC and CFTC
33 "Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs)" (2011) Financial Stability Board

2.21 While regulators and policymakers recognise in principle the importance of seeking "to ensure that financial markets continue to fulfil their role of financing the real economy, by channelling investments and savings, facilitating capital formation and efficiently allocating and transferring risks"[34], the practical focus underlying that appears to remain embedded in an inherent reliance on efficient market theory, with a focus on technical issues around of liquidity and trading. This is a concern. Regulators appear to recognise that developments in the market may also have had negative effects, there is a concern that their practical focus and priority appears to remain targeted at market integrity[35] and efficiency,[36] primarily for (orderly) trading, at the expense of giving primacy to the core role and purpose of the capital markets and that this will encumber the consideration that may be given to the range of reforms needed in the capital markets.

2.22 One topical but 'small' example of this issue is evident in the FSA's approach to listing eligibility and the free float requirements (e.g. LR6.1.19), where their sole consideration in exercising discretion in lowering the thresholds appears to be driven by liquidity issues. Another would be the acceptance of sell side innovations that enable companies to buy-back shares at premiums far in excess of the 5% limit set out in LR12.4.1(1), with premiums of around 30% having been paid in some cases. Such strategies may well serve the primary purpose of enabling companies to maintain buyback programs during closed periods (see our answer to Q.3), but also illustrate some of the concerns there are with the regulatory focus and philosophy that has developed.

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

3.1 Again building on the general context we discussed in our answer to Q.1, we have focused our answer to this question on some of the specific dynamics that underlie the issues noted there. Set against the context of short performance/reporting cycles and the challenge faced by companies in breaking away from the short term dynamic, we have focussed on the earnings 'game', misaligned incentives and how they interact in relation to issues like M&A and share buybacks.

3.2 We do recognise that, unlike the US, the UK does not require quarterly reporting per se, but the short term reporting cycles do still contribute to short-term thinking and can discourage investment for the long-term, given the impact that could have on short-term performance. It is also important to recognise the effects of peer pressure and competition between companies in this context.[37]

3.3 Currently in the UK public companies are required to issue two interim management statements as well as half-year and full year accounts. Whilst this is less onerous than a requirement for full quarterly reporting, the underlying dynamic and focus on short-term earnings is still evident, as we outline in our answer to Q.1. We do, therefore, welcome the fact that the recent proposal for an amended Directive on Transparency Obligations proposes that requirements for interim management statements are dropped.

3.4 Unilever Plc is often cited as an example of the hurdles companies have to overcome and mind set needed in breaking from the short term dynamics that exist. Their move away from providing regular short-term guidance to embed a longer-term approach and practices was welcome and interesting. Initially the response from short term investors pushed the share price down around

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34 See Chapter 2, The Role of the Markets, in "Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency" (2011), IOSCO Technical Committee

35 Defined by IOSCO as "the extent to which a market operates in a manner that is, and is perceived to be, fair and orderly and where effective rules are in place and enforced by regulators so that confidence and participation in the market is fostered."

36 Defined by IOSCO as "the ability of market participants to transact business easily and at a price that reflects all available market information. Factors considered when determining if a market is efficient include liquidity, price discovery and transparency."

37 See for example http://www.ft.com/cms/s/0/5d6c466c-6a00-11e0-86e4-00144feab49a.html#axzz1dOaOWc00

10%, but it subsequently outperformed.[38] Paul Polman, Unilever's CEO, evidences both the mind set needed and the challenges his and other companies face when trying to take a long term view.[39] This highlights the importance of recognising that the dynamic here should not be characterised as just a capital markets issue. Unilever is not alone though in having sought to face up to this challenge and, looking at more cyclical businesses, others that would be worth exploring the issues with might include Aggreko Plc or Marshalls Plc.

3.5 Looking at the dynamic in which this tension exists, from a market perspective, as Prof. Alfred Rappaport neatly summed it up: "Financial Analysts fixate on earnings at the expense of fundamental research. Corporate executives, in turn, point to the behavior of the investment community to rationalize their own obsession with earnings. Short-termism is the disease; earnings and tracking error are the carriers."[40] As a generalization, we do agree and this is fed by the corporate reporting dynamic,[41] which we feel needs to be one of the priorities for reform.

3.6 We would encourage the review to have regard to existing work that has been done on this dynamic and, would highlight the following as two examples of that:

- In response to the concern that America was caught in a perilous pattern of increasing volatility, decreasing investor returns and increasingly bad practice, the Dean of Toronto's Rotman School of Management, Roger Martin, recently published 'Fixing the Game' examining the dynamics involved and set out a 'game plan' for redressing the balance, which may be of interest.[42]
- Beginning in September 2005, the CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics co-sponsored a "Symposium Series on Short-Termism." The insights from those symposia, were published in 2006,[43] with participants (thought leaders from the corporate issuer, analyst, asset and hedge fund manager, institutional investor, and individual investor communities) confirming the issues around the obsession with short-term results by investors, asset management firms, and corporate managers collectively, which lead to the unintended consequence of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance.

3.7 Given our own interest as an investment house in the very long-term challenges that exist for both the capital markets and our economies, we have been seeking to contribute to the development of thinking on these issues and have already commissioned work around various key themes and related issues. The first of these pieces of work, "Sustainable economy in 2040 – a roadmap for capital markets" was produced and published by the Forum for the Future in September 2011.[44] Another, that we refer to in our answer to Q.6 (also Appendix 2), focuses on the incentives in the capital markets. At the same time we have been working internally on others including asset manager transparency and accountability to clients (see our answer to Q.7) and asset allocation (see our answer to Q.10).

3.8 On corporate reporting we will be outlining our views in our response to the BIS consultation on narrative reporting, about the need for a much more strategic focus. More broadly, we believe that the current framework and practices mean that many companies are failing to provide the level of information needed for investors to be able to judge the sustainability of businesses, affecting long-term strategic analysis. Globally, of 20,000 publicly listed companies recently

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38 http://www.mckinsey.com/en/Features/Capitalism/Paul_Polman.aspx
39 http://www.managementtoday.co.uk/features/1055793/MT-Interview-Paul-Polman-Unilever/
40 "The Economics of Short-Term Performance Obsession" (2005) A.Rappaport
41 See for example "The Economic Implications of Corporate Financial Reporting" (2005), J.Graham et al
42 http://hbr.org/product/fixing-the-game-bubbles-crashes-and-what-capitalis/an/10416-HBK-ENG
43 "Breaking the Short-Term Cycle: Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors and Analysts Can Refocus on Long-Term Value" (2006) CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics
44 See http://www.forumforthefuture.org/sites/default/files/project/downloads/aviva-sustainable-economy-full-report-web.pdf

reviewed through Bloomberg's database, less than one in five publicly reported on even a single piece of quantitative data on environmental, social or governance issues.[45]

3.9 Turning to examples that illustrate the various tensions and dynamics that coincide in the way capital markets interact with companies, we focus on mergers & acquisitions and share buybacks. Although not a good example to use, the takeover of Cadbury by Kraft was often cited as an example of shareholder short-termism. While the nature of and changes seen in the company's share register are interesting ultimately, for Cadbury shareholders, Kraft paid a price that Warren Buffet, a major Kraft shareholder, termed a "very fancy price" and the decision to sell was, ultimately, rational. The event was, nevertheless, a interesting case study on the power of brands and their perceived intangible value.

3.10 As long-term investors in UK equities, we do recognise that policymakers might see a broader issue here. While one school of thought holds that the ownership of 'British' companies is irrelevant, as long as it provides plenty of jobs, there are some flaws in that view in practice. Not least experience shows that in adverse conditions or cost cutting exercises, foreign companies can and do close their British operations before their operations in their home countries. We do not advocate protectionism; however, each loss of a company to foreign ownership does reduce the UK investment universe and options for UK equity funds and in aggregate, over time, will have an influence on the allocation of capital to UK vs overseas equity. In that context, we also believe consideration could usefully be given, in looking at the effect of market structures and benchmarks (e.g. market cap weighted indices), to the extent to which the emphasis on and liquidity created for large companies, comes at the expense of providing risk capital for smaller growth companies in the capital markets. This is particularly important in light fo the capital allocation trends we reference in our response to Q.10.

3.11 In terms of M&A deals like Prudential/AIA, G4S/ISS and others, it has been notable that discussions about them, alongside the consideration given to the risks of the deals, often see both supporters and opponents asserting the a long-term interests in their stance, while implying short-term motivations on the other side. Part of the problem is that concepts like short or long-termism can mean very different things to different people, depending on the context, circumstances and the perspective, as well as the incentives, people have.

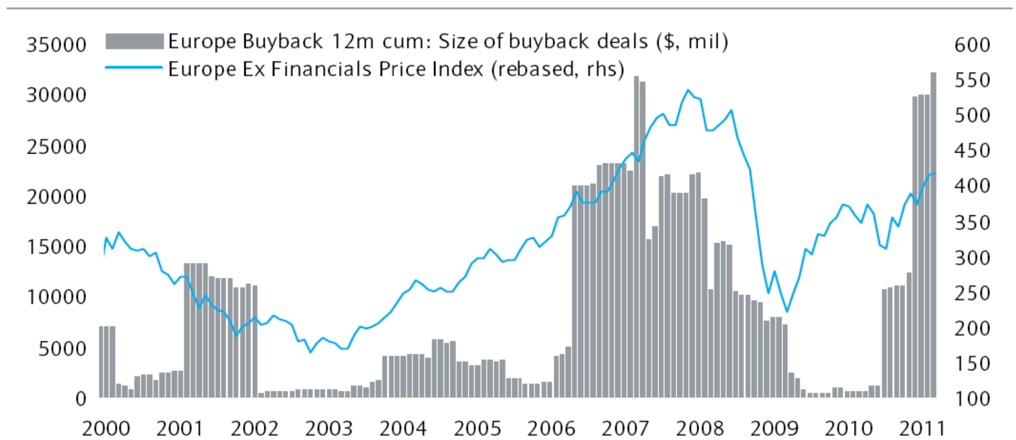
3.12 The role of incentives in this context is particularly important. In terms of M&A activity generally, the analysis of pay and performance produced for the High Pay Commission[46] highlighted that: "Of 757 companies that have featured in the FTSE 350 over the decade, just 124 or 16.4% of the total have remained on the index since 2000. Since 2000, the average value of LTIPs in survivors has gone up by 488%, but the average value of LTIPs received in non-survivors has gone up by 1,476%'." While not providing full picture of the issues involved, this is nevertheless significant, as half or more of the mergers, acquisitions, and alliances that take place, fail to create significant shareholder value both in our experience and according to much of the research that has been undertaken on major deals.[47] For some time now, academics have flagged that company size is the factor that has the highest and most significant positive correlation with levels of executive pay.[48] This is echoed in academic work on UK M&A,[49] which has highlighted the significant and substantial executive pay increases, in excess of those generated by the growth in firm size, consequent upon mergers.

3.13 It is not just in M&A that this dynamic is evident. In 2005, Richard Dobbs and Werner Rehm, writing in the Mckinsey Quarterly[50] noted that the market generally applauded share buybacks

45 http://www.guardian.co.uk/sustainable-business/aviva-chief-city-failure-sustainability
46 "What are we paying for? Exploring executive pay and performance" (2011), Incomes Data Services
47 See "Deals that create value" (2001) Biesharr et al. or "Why do acquisitions so often destroy Shareholder Value?" (2002) PA Consulting Group or "Deals from Hell: M&A Lessons That Rise Above the Ashes" (2005) R.Bruner
48 "How Much Does Performance Matter? A Meta-Analysis of CEO Pay Studies" (2000) Tosi et al.
49 See for example "Merger Activity and Executive Pay" (2002) Gima et al.
50 "The **value** of share buybacks" The McKinsey Quarterly, 2005 Number 3

"making buybacks an alluring substitute if improvements in operational performance are elusive." The city's leading proponent of Behavioural Finance, James Montier, has noted that "Our industry has a bad habit of accepting statements at face value, and rarely examining the empirical truth underlying them. One good example concerns stock buybacks. Many investors thought that repurchases were a substitute for dividends…. Surveys show that corporate managers use buybacks to raise EPS growth and offset options dilution." [51] While share buy backs do have a useful role to play as one mechanism available to companies to manage their capital efficiently, we do agree with this sentiment.

3.14 As Barclays Capital noted recently, history tells us that share buy-backs are often done at a point in time when shares are overvalued, rather than undervalued, thus destroying shareholder value.[52]



Source: Barclays Capital, Datastream.

3.15 Whilst traditional theory argues about dividend irrelevancy there is significant empirical evidence to suggest that sustainable increases in dividends provide a much stronger signal than share buy-backs. Despite this, share buy-backs are increasingly popular and any analysis of dividends in isolation to the other ways in which companies make distributions (including the paying off of debt), risks being unrepresentative. Nevertheless we do recognise that the market's short-term response to dividend cuts has not helped. .

3.16 Picking up again on the theme of M&A, there is a clear read across. The relative attractiveness of a transaction is often presented in terms of whether it is earnings accretive, which under new accounting rules it generally will be, before the costs of restructuring.[53] Management incentives are generally driven off 'adjusted' metrics, not least removing 'one-off' and 'exceptional' costs. Amongst other things, earnings accretion can just reflect the difference between the PE (price to earnings) of the consideration (either cash or shares) compared with the target's PE and is not a good metric to judge whether M&A creates shareholder value.[54] That said, there is no reason to believe that the effect of this dynamic is limited to the takeover market or share buybacks and previous research has provided evidence that financing, reporting, and investment decisions are all impacted by myopic mis-valuation.[55]

3.17 A way needs to be found to break this dynamic and re-align the incentives and economic interests of all participants in taking a longer-term approach. This applies not just to capital markets participants but to Boards of directors and their remuneration committees.

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[51] "Mind Matters – Investment myth busting: repurchase rip-offs" (2009), Societe Generale, Cross Asset Research
[52] "Dividends or Share Buy-backs: how should companies return cash to shareholders?" (Sept 2011), Barclays Capital
[53] "Merger Valuation: Time to Jettison EPS" (2005) Dobbs et al
[54] "Why EPS enhancement does not matter in M&A" (2006) Stephen Cooper, UBS Investment Research
[55] "Does Investor Misvaluation Drive the Takeover Market?" (2006) Richardson et al, Journal of Finance

4. 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.

4.1 From our parent company's perspective, by and large the shareholders want the business to take a longer term view and do not encourage the group to take a short term approach. That said, we are given to understand that it is notable that the pressure on the group's shareholders seems increasingly short term.

4.2 In terms of the company's discussions with investors the latter are considered to be interested in the group's long term prospects and that forms the basis of the majority of their discussions with investors. Their view on short-term share price movements is that while they are important to be aware of generally, given they can be driven by a large number of factors that are outside of management control, they don't overly influence management's focus.

4.3 From our parent company's perspective, quarterly reporting seems to divide the analyst community, some see it as a useful signpost as to where the business is and others are less convinced. It was notable in this context that some competitors produced significant amounts of data at the third quarter that appeared to add only limited value.

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

5.1 We do believe that there are areas where Government (not just the UK's) policies and regulations do have a clear effect and impact on investment and we have highlighted some of these below. Separately we touched on some of the perceived issues in the regulatory approach to and philosophy on the capital markets in paragraphs 2.21 and 2.22.

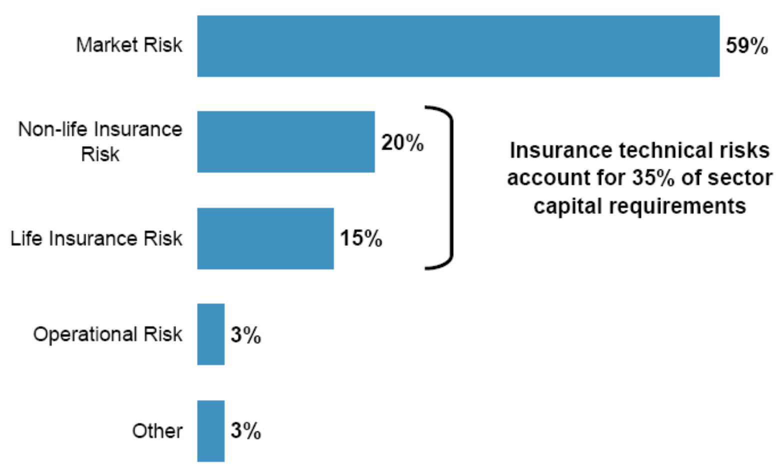
5.2 We discuss asset allocation trends more generally in our response to Q.10, but in that context note that a real impact of regulation and the accounting standards has been its contribution to the trend amongst long term investors of moving away from the provision of long-term equity risk capital and switching into government bonds and other fixed income investments (as well as other asset classes). Set against the increasing noise of short-term trading, this trend creates real concerns that long run investment returns will be damaged and has had unintended consequences in applying pressures at times of financial stress. It can drive participants to standard types of behaviour such that risk is not effectively diversified and resulted in certain investors having to sell equities when valuations are depressed, even though the risk premium was attractive on a long-term view, crystallizing losses and depriving beneficiaries of the ensuing returns. The nonsensical treatment of sovereign debt as risk free for capital purposes just adds to concerns about this dynamic.

5.3 A prime example of this is seen in the solvency requirements that are impacting how and what investors, particularly insurers, are allocating capital to, in juggling the technical demands of the frameworks. Not least they create significant pressure to shift from being long-term providers of equity risk capital to being holders of lower risk assets such as sovereign debt. There is an understandable desire by governments and regulators to ensure that pension funds and insurance companies have sufficient means to meet their liabilities, but the ever more stringent requirements regarding the forms of assets used to back liabilities, does create other issues.

5.4 In the 80s, the Section 59 of the Insurance Companies Regulations 1981 and the Government Actuary's mismatching rule required a lower valuation rate of interest to be used and higher reserves to be held if an office held equities rather than fixed interest instruments. Even then the regulations were placing pressure on offices to invest more heavily in fixed interest, with consequential impacts over the long term for policyholder returns.[56] The Equity Backing Ratio has played its role in this dynamic alongside Individual Capital Assessments (ICA). While the policy objectives of such frameworks and the reasons behind them are understood, alongside the general benefit of acting as a catalyst for improvement in the management of funds, the scope for capital management to become a limiting factor in investment strategies also needs to be understood. One consequential strategy, in the right circumstances, can be to disinvesting from equities and purchase equity put options, which reduces the ICA significantly.[57] The potential issues and risks in this dynamic are expected to continue under forthcoming regulatory initiatives such as Solvency II.

5.5 Studies of the strategic implications of the upcoming Solvency II guidelines, [58] highlight the potentially profound influence they will have on capital budgeting and risk management for insurers. We do not propose to debate Solvency II itself, but rather to highlight some of the implications it has for the investment operations of insurance companies as strategic asset allocation and asset duration, has a large influence on insurer's risk-return trade-off under Solvency II. An insurer's investments will influence not only the available capital (as is the case under Solvency I) but also the required capital. The Solvency II ratio will therefore be more clearly sensitive to investment risk, in two different ways. As insurers seek to reduce short-term risk (as measured by the required capital) one of the obvious issues is that long-term expected returns are likely to decrease. Similarly, a low solvency ratio can also be improved by reducing risk by exchanging risky assets (such as equity) for fixed income ones. Within the increasingly pro-cyclical frameworks and accounting standards that have been adopted, the demands of ongoing risk reduction can coincide with adverse economic/markets conditions, requiring the sale of equities after sharp drops in value.

5.6 In a detailed quantitative study of the impacts of Solvency II[59], Morgan Stanley and Oliver Wyman's highlighted the point that only around 35% of the insurance sector's risk budgets comes from 'technical' risks, with market risk being the dominant source:



Source: Morgan Stanley Research, Oliver Wyman

5.7 Insurers are significant participants in investment markets, with potential macro implications from their asset allocation decisions. While the actual effects of and responses to Solvency II will vary according to the nature and sophistication of individual firms, the Morgan Stanley and Oliver Wyman analysis underlines the possible effects on investment; for instance:

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56 See for example "Asset and Liability Studies on a With Profit Fund" (1992) T.Roff
57 For examples see "Breathing life into with-profit funds" (2009) P.Kettlewell
58 See for example "The influence of Solvency II on an insurer's strategic policy" (2010) Montulet et al, EDHEC-Risk Institute Industry Analysis
59 "Solvency 2: Quantitative & Strategic Impact - The Tide is Going Out" (2010) Morgan Stanley & Oliver Wyman

(i) Insurers are unlikely to markedly increase equity allocations given their less attractive return on Solvency 2 capital relative to bonds. Equity and property are only expected to get significant allocations for those insurers with a very high market risk appetite and we may see more routine use of derivatives to 'outsource' unrewarded risk (e.g. caps and collars to manage equity risk);

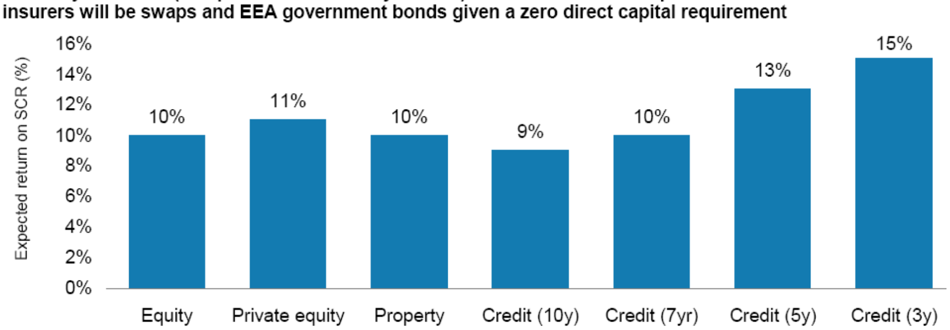
(ii) demand for long-duration corporate bonds will likely decrease, affecting corporates' ability to issue longer maturity bonds. Government bonds and swaps have zero direct capital requirement – insurers will be highly incentivised to invest in these asset classes; especially since they can help match liabilities (subject to taking a view on sovereign risk).

(iii) Insurers will plan forward to enable a gradual transition, not just by shortening the duration of credit portfolios, but also looking to reduce exposure to private equity investments (which make take time to exit).

(iv) insurers may continue to have an appetite for longer duration swaps, swaptions and, importantly, government bonds, which carry no direct capital requirements (a notable point given the European sovereign crisis)

5.8 To further illustrate the point, the graph below shows the expected relative returns on capital for investing in different asset classes for non-profit liabilities, i.e. the type of liabilities where the shareholders bear all of the market risk, assuming that any interest rate risk is hedged using swaps and other interest rate derivatives. In addition to illustrating the relative unattractiveness of equity, the authors also recognised that the capital requirements for equities could increase further (i.e. returns on capital would be even lower) if used to back interest rate guarantees, e.g. in participating liabilities. This depends on the level of buffer capital within participating funds, as well-capitalised funds, with a high policyholder surplus, could hold higher levels of equities.

Risk-adjusted return on capital from different asset classes under Solvency 2 – short-dated credit appears relatively attractive (compared to other 'risky' assets). However the most capital efficient assets to hold for insurers will be swaps and EEA government bonds given a zero direct capital requirement



	Equity	Private equity	Property	Credit (10y)	Credit (7yr)	Credit (5y)	Credit (3y)
Standalone capital requirement (%)	39.0	49.0	25.0	16.5	11.5	8.2	4.9
Expected excess return (%)	3.3	4.3	1.9	1.3	1.2	1.1	0.9

Assumes that liabilities are cashflow-matched using swaps and other interest rate derivatives.
Source: QIS5 technical specifications, Bloomberg, Morgan Stanley Research, Oliver Wyman

5.9 As we noted in our response to the BIS consultation on "A Long-term Focus for Corporate Britain", IFRS standards are pro-cyclical in nature and played a notable role in facilitating and exacerbating both the dynamic and behaviours that drove the credit bubble and the subsequent crisis. Despite a common assertion of some standard setters, IFRS are not just presentational, they have real world effects, not just for pensions, capital management, behavioural biases, risk taking, and ability to be prudent (e.g. on loan loss provisioning) but also, and not least, financial product innovation. The effects and problems have arisen both as a result of how the standards have been implemented and their effects on accounts. Not least, critical concepts like prudence and accounting conservatism have been superseded by a compliance orientated model. Concepts like the "true and fair view" have also been diluted. IFRS compliance allows significant discretionary scope within fair values. Anecdotal evidence from auditors has highlighted the effects of de-prioritising prudence. It can be argued that Warren Buffet's concerns about mark-to-myth were borne out in the crisis. The standards have also resulted in the Companies Act accounting requirements being obfuscated, e.g. in relation to distributable reserves and dividends. From an investor perspective, a significant proportion of bank capital raising over the crisis actually went to redress precisely the results of that.

5.10 Looking at the broader accounting frameworks, long-term investors are interested not just in the decision usefulness model pursued by accounting standard setters, which is more orientated towards the trading markets than it is to corporate stewardship or to long-term ownership and investment. Its focus on fair value and earnings plays well into the dynamics we have referred to elsewhere in this submission. As the preliminary report of The Sharman Inquiry[60] noted, investors and "quite a lot of others" have raised questions about the suitability of IFRS accounts as a basis for assessing the solvency of businesses. As the report notes, overall, capital management is important to us as shareholders. However, IAS 1 disclosures are not generally providing what long-term shareholders want, although they could in theory be used to do so.

5.11 The evidence the Sharman Inquiry received suggests that there are behavioural disincentives for directors to make frank going concern risk disclosures, except in fairly advanced stages of distress, either as a result of: fear that disclosure may create a self-fulfilling prophecy; an overly optimistic outlook; or a degree of denial. In the Inquiry's view assessing solvency risk including capital adequacy is an important part of the going concern assessment (and, we would argue, accountability) for all entities not just those in regulated financial services industries. As 'owners' of businesses, we couldn't agree more. The problem of getting effective going concern opinions (and related audit reports) is not new. Given the concerns that existed when the going concern statement was first introduced, a study was undertaken by the ACCA[61] in 1999 of 124 companies that failed between 1987 and 1994. It found that only one in seven was qualified on a going concern basis in the last annual report and accounts prior to the failure, despite the related APC Audit Guideline[62] that had been issued in 1985. While audit standards were subsequently updated,[63] the current crisis has again highlighted deficiencies in this area and the ACCA study's findings on the effects of going concern qualifications remain interesting, having found that:

> *"Contrary to the self-fulfilling prophecy argument, in particular, we have found that 80% of audit reports qualified on a going concern basis are followed by a subsequent set of accounts rather than company failure. Moreover, two out of five qualified companies enter into major financial restructuring or a rescue rights issue, showing that receipt of a [going concern qualification] does not pose an insurmountable obstacle to raising new finance."*

5.12 Perhaps one of the most significant areas where this dynamic can create concerns is in banking. For banks there are trade-offs between higher short-term earnings and prudent liquidity risk management. During 'good times', such trade-offs are often forgotten but they become too evident when the business cycle turns or market disruptions make it more difficult and costly to tap several potential sources of funding, including market funding sources (ex. Inter-bank lines of credit), or to attract or retain deposits.[64] Ultimately, the credibility of the going concern basis of accounting was undermined as a result of its handling during the crisis.

5.13 Another clear example of the effects of IFRS is found in relation to pension funds.[65] The Chairman of the National Association of Pension Funds (NAPF), Lindsay Tomlinson has repeatedly and correctly highlighted the damage that accounting standards have done to defined benefit pension provision. There have been significant closures of defined benefit pension schemes in the private sector reflecting a growing unwillingness of scheme sponsors to take on

[60] "Going Concern and Liquidity Risks: Lessons for Companies and Auditors – Preliminary Report and Recommendations of the panel of Inquiry" (2011) The Sharman Inquiry
[61] : "Audit Report Disclosures of Going Concern Uncertainties: A Continuing Puzzle" (1999) ACCA Research Note No.60, Citron and Taffler (Chartered Association of Certified Accountants).
[62] : "The Auditor's Consideration in Respect of Going Concern" APC Guideline, 1985/1.
[63] : e.g. SAS600 and SAS 130.
[64] "The Heavenly Liquidity Twin – The Increasing Importance of Liquidity risk" (2009) F.Montes-Negret
[65] See for example "The Impact of UK Pension Accounting Rule Change on Pension Curtailment Decisions" (2007) Klumpes et al.

increasingly volatile and uncertain, open ended future liabilities. Accounting treatment played its part in that with pension scheme assets being marked to market and liabilities being discounted using AA-rated bond yields, causing pension schemes to move out of equities into bonds to better match their liabilities as required by the frameworks they operate under.

5.14 Given the difficulties of engaging standard setters on these concerns, the NAPF commissioned the University of Leeds to investigate and report on the effects of IFRS on pensions.[66] Perhaps unsurprisingly, they found that the current pension accounting, under IAS 19, has been detrimental to the sustainability of the defined benefit pension scheme as it removes the interaction that occurs between pension assets and pension liabilities and asset/liability cash flows when both are valued using discounted cash flows. Its volatile, pro-cyclical nature has led pension schemes to divest real asset investments, such as equities, and to investing in other financial investments, such as long-dated index linked gilts and corporate bonds that are a better match for the estimated accounting liability. The systemic effect of this has been to exacerbate the bubble in long-dated bonds and, in particular, index linked gilts. Not least, this has contributed to the reduction in the capital commitment to equity but has also increased the cost of pension provision given the lower long-term returns of gilts and bonds.

5.15 These are just some of the issues that arise out of the standards, with others including the fair valuation of own debt and the incurred loss model for loan loss provisioning, amongst others.

5.16 Although some policy makers appear to consider investment to be particularly risky, it is not only essential to the (re)allocation of capital within economies to support productivity and growth, but is also an integral part of the provision of insurance services, pensions and savings products. The positive contributions made by these to the economy and society needs to be recognised and supported. In line with the focus of the review, consideration does need to be given to the ways in which the UK tax system may act as a disincentive to long-term investment in providing equity capital to companies. Amongst the issues we would highlight are the following:

- As we have noted we are opposed to the European proposals for a financial transaction tax. As matters stand in the UK, an investment in shares triggers stamp duty on purchase, but the portion of trading in large, medium and to a lesser degree small companies that is subject to stamp duty has fallen, with long-term risk averse investors such as insurance companies bearing the brunt of that. Other participants can avoid the cost using, for example, derivatives and contracts for difference (CFDs), which also allow them to trade on margin, which can allow market participants to commit only a 'margin' or deposit of as little as 10% of the contract value. The impacts of stamp duty on companies' cost of capital and its implications for investment and competitiveness were neatly summarised by Oxera in 2007.[67]
- Investors' tax treatment on equity should be revisited. On broad conceptual grounds, there is no good economic case for treating equity investors any differently from debt investors. Both are ways of providing capital to businesses and the provision of long-term risk bearing equity should not be penalised in favour of leverage.
- Linked to the last point, for those least able to save, particularly those who will be reliant on stakeholder, personal or defined contribution pensions, just one damaging example of the trend that has been seen was the removal of the tax credit, which allowed tax-exempt shareholders such as pension funds to receive a boost to income through gross dividends.
- Amongst other things, the taper relief that was introduced into the UK taxation regime with effect from 6th April 1998, which was withdrawn after 10 years in the Finance Act 2008 should be revisited, with a view to incentivising long-term saving and capital commitment. In addition, indexation allowance should also be revisited.

5.17 There are reservations amongst some investors that shareholders liaising with each other and acting collectively to address stewardship issues continues to be a problem and that FSA

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66 "Accounting for Pensions" (2011) Clacher and Moizer
67 "Stamp Duty on share trading: the effect on UK listed companies?" (2007) Oxera

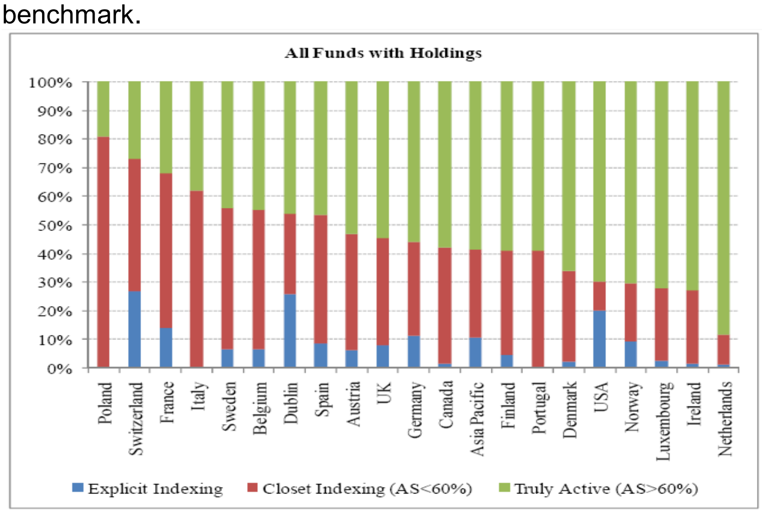
regulations (and the related European Directives) and the Takeover Code, make such activities ones that are best minimised or avoided. Although both the FSA and Takeover Panel have sought to clarify these issues, we believe that there is scope for them to engage more closely with market participants who remain concerned, to see whether and to what extent such reservations can reasonably be addressed.

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

6.1 In responding to this question we focus on three issues. The first relates to aspects of the mandates awarded to clients and the dynamics around that. The second looks at the issue of the related stewardship activities that should go hand in hand with the commitment of equity risk capital into businesses. The third touches further on some of the issues around incentives and fee structures.

6.2 In terms of the broad long-term trend in pension funds' approach to selecting asset managers, the changes in the nature of mandates (i.e. from balanced mandates to specialist mandates) and the rationale behind that have been reviewed independently, with the results providing support for pension funds, at least on average, rationally choosing the way they have changed their delegation structure. [68] It was notable, however, that in response to the resulting difficulty in coordinating multiple managers, pension funds allocated reduced risk budgets[69] (i.e. tracking errors) to the managers as part of that process.

6.3 Linking back to the issues we noted in our response to Q.2, as HFT activity increases volatility it is notable that this in turn amplifies the tracking errors of traditional long equity funds. With asset owners and consultants often using tracking error to gauge how much active risk is being taken in order to achieve the return relative to the benchmark index, this may, to some extent, inhibit long-term investment decisions. Looking back to 2007, as market volatility was increasing, the issue of closet indexing was notable.[70] While traditional index replication funds have commensurate, low fee structures that is not the case with active funds that closet index track. Looking at UK mutual funds, academics put the proportion of UK active mutual funds managers that were closet index tracking in 2007 at around 40%, compared to 10% in the US.[71] This is significant, not only as it detracts from the efficient allocation of capital to the real economy, but also given its association with underperformance compared to both truly actively managed funds and the benchmark.



Source: The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees, and Performance (2011) Cremers et al.

68 "Decentralized Investment Management: Evidence from the Pension Fund Industry" (2010) Blake et al
69 For an explanation of risk budgeting see for example: "Risk Budgeting Theory and Applications" (2006) S.Peterson
70 "Active Share and Mutual Fund Performance" (2010) A.Petajisto
71 "The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees and Performance"(2011) Cremers et al

6.5 As a result, the effects of benchmarks, tracking error restrictions and closet indexing, which as a practice can be indicative of a less competitive and higher cost practices[72], are issues that merit further examination.

6.6 Picking up on these issues and others (see answers to questions 7 and 8), we believe it is worth noting the 2007 global survey sponsored by the International Centre for Pension Management on the relationship/dynamic between pension funds and their agents.[73] This provided an indicative insight from global pension funds, academics, consultants, NGOs, regulators and international organizations on the relative importance of various facets of the dynamics being looked at. Consideration included whether: fund manager performance should be reviewed over longer time horizons that the typical quarterly cycle; excessive reliance on measuring performance relative to a market index should be reduced; pension funds should have voting and engagement policies; those should be integrated into the investment process; shareowner activism should be given more weight in the selection and retention of fund managers and other matters. Of the issues listed above, all received a marked majority of support as important to varying degrees, although there were some interesting variations amongst the different categories of respondent.

6.7 On short term performance measurement by pension trustees, we believe that this can put pressure on investment managers to target short term returns for fear that they will lose the business because of a short period of under-performance. We believe that the broad position found in the joint survey by MORI commissioned by the NAPF and IMA in 2004[74] remains largely unchanged, with 66% of pension funds formally reviewing fund manager performance every quarter (92% annually or less), despite the key investment period for trustees appearing to be longer than a rolling or calendar year for 62% of them. This can create incentives that affect fund manager's approach to risk taking depending on the circumstances, which may merit further consideration.[75]

6.8 Turning to the stewardship aspects of equity investment, in the UK, the Stewardship Code sets out clear good practice. Although there are clearly examples of effective practice and activity, the integration of stewardship activities and indeed what those activities are deemed to involve varies between fund management houses. Except for the most focused funds and listed turnaround vehicles, which often have highly concentrated portfolios and a relatively high level of resource per investment, the levels of resource that are available or indeed viable mean that a selective approach and prioritisation is needed. This is particularly true when spread across hundreds or indeed thousands of investments globally. We discussed the dynamics of Stewardship and engagement in more detail in our response to the BIS consultation on "A Long-term Focus for Corporate Britain".

6.9 The take up and/or disclosure on the Code, by Asset Owners, has been more muted than amongst asset managers. Not least this is an area where considerable uncertainty and lack of conviction still exists and to be fair the frameworks hardly encouraging. Policymakers need to build on the solid foundations provided by the UK's Stewardship Code and, amongst other things, the Pensions Regulator should be asked to re-examine its own regulations and to re-task its Investor Governance Group to take a more proactive interest and review their guidance around the Myner's Principles. This work should also take account of market developments and how these frameworks should accommodate trends, such as that towards Fiduciary Management.

6.10 That is not to say that there hasn't been support for asset owners to embrace 'stewardship' as part of their investment principles:

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72 Ibid.
73 "Results of a Survey on 'Identifying Priorities for Collaboration amongst Pension Funds and their Agents'" (2007) D.Guyatt
74 "NAPF/IMA Short-Termism Study Report" (2004) MORI
75 See for example, "Employment Risk, Compensation Incentives and Managerial Risk Taking - Evidence from the Mutual Fund Industry" (2007) Kempf et al

- The 2005 'Freshfields' report for the UNEP FI Asset Management Working Group.[76]
- The NAPF guide for pension fund trustees on stewardship.[77]
- FairPensions study on fiduciary duty.[78]

or, that they haven't dealt with it. The common approach to this however, has been to delegate responsibility to asset managers. We discuss this dynamic further in our response to Q.8.

6.11 Turning to the issue of incentives, we believe that this (alongside fee structures[79]) do need to be reviewed. From a broad perspective, we have already scoped and commissioned a project with Tomorrow's Company to examine the impact of incentives in capital markets and the effect that these have on behaviours and decisions, with a view to understand how they might be improved to incentivise sustainable behaviours and outcomes (see Appendix 2).

6.12 Most institutional client mandates tend to run for a minimum of 3 years. However, despite the long term nature of the liabilities institutions face, a norm for fund manager incentives is to have one and three year rolling performance horizons, i.e. the short and medium term, but not the long term. Although the dynamic is not always so simple, asset managers know that if they under-perform for a short period within this time they could be replaced. Therefore, some asset managers may take risks to get the required returns over a shorter time frame.[80] That said, some consideration might also be given the findings of work done on the persistence over time in the performance of UK active asset managers. One example of that work was undertaken in the context of the advent of low cost stakeholder pensions in the UK and whether there was a case for pension funds to use active management.[81] Efforts, such as that of the Universities Superannuation Scheme, have been made in the past to devise longer term mandates but the need to plug pension scheme deficits has, in recent times, been the greater priority and so aggressive pursuit of short term performance continues.

6.13 According to National Employment Savings Trust (NEST) chief investment officer, Mark Fawcett, improving companies through corporate governance will remain "a fantasy" until pension trustee's better align their managers' incentives. Speaking at the Organisation for Economic Co-operation and Development - WPC World Pensions and Investments Forum in December 2010, Fawcett suggested that pension scheme trustees are too focused on short term returns by hiring and firing fund managers on a three year cycle, whereas they should be looking at five years as a minimum, maybe ten. Fawcett maintains that "until pension funds start behaving the right way by aligning the incentives for fund managers... the idea that corporate governance is going to make a change is unrealistic."[82]

6.14 We believe that some Trustees consider it just as much a risk to award long term mandates as to not remove under-performing fund managers before their mandates are completed. However, as it takes time to discern the extent to which a fund manager's performance is attributable to luck or skill, we consider it often inappropriate for managers to be judged solely on their short term performance. Indeed, over time as luck evens out, skill, where it exists, will shine through. Academics have, in the past,[83] examined the process in which asset owner hire and fire their fund managers, a tendency to hire managers who had recently performed well and fire managers who had recently performed badly. The point of note was that the fired managers, on average,

76 "Legal framework for the integration of the Environmental, Social and Governance issues into institutional investment, report for the UNEP Finance Initiative Asset Management Working Group" (2005) Freshfields
77 "Stewardship made simple: Practical steps for Pension Fund Trustees in applying the Stewardship Code" (2011) NAPF
78 "Protecting our best Interests" (2011) Fair Pensions
79 See for example "Fund Management Fees" (2010) Terry Smith (http://www.terrysmithblog.com/straight-talking/2010/09/fund-management-fees.html)
80 See for example "Employment Risk, Compensation Incentives and Managerial Risk taking – Evidence from the Mutual Fund Industry" (2007) Kempf et al.
81 "Performance Persistency of Pension Fund Managers" (2002) I.Tonks
82 See Professional Pensions, 15 December 2010
83 See for example "The Selection and Termination of Investment Management Firms by Plan Sponsors" (2008) Goyal and Wahal

subsequently outperformed those hired, albeit marginally, notwithstanding the sizeable transition costs incurred in changing managers. Others have looked at the issue more broadly to take into account behavioural aspects of the relationships and also merit consideration.[84]

6.15 On a slightly different tack, another concern for us and other investors are the levels of fees paid by companies to their bank advisers and the behaviours that dynamic may be encouraging. This issue has been examined by the investment industry in relation to Rights Issues, with the subsequent report[85] confirming widespread concern amongst institutional investors about the high level of underwriting fees banks charge, and the lack of transparency around how much is actually paid, to whom it is paid and what is paid for. Fee levels have been increasing for many years and remain high, despite market participants' steps to reduce significantly the risks associated with rights issues. The OFT's subsequent ducking of the issues was deeply disappointing. IPO fees, bank syndication and the promotion of valuations that are unrealistic are another illustration of the dynamic behind the concerns and we welcomed the clear expression those concerns by Blackrock's Luke Chappell and James Macpherson in their May 2011 letter to investment banks.

6.16 In contrast to the disappointing OFT stance, the steps taken by the Takeover Panel to improve disclosure of adviser's fees in takeover situations. Given the issues we highlighted in our response to Q.3, this has been most welcome as an initial step. Such fees have been of interest given their size, both in successful and failed transactions and given concerns that have existed around the conflicts that are perceived to exist.[86] These concerns are compounded by the fact that the advisors' advice to boards or independent non-executives systematically comes to the conclusion that transactions are fair, not least given the incentives involved.[87]

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.

7.1 In responding to this question, we touch on three aspects of the issues the call for evidence touched on. The first disclosure is on the disclosure of material stakes, the second is on asset manager disclosures and th ethird is the role of investment consultants.

7.2 The disclosure of major shareholdings and other economic interests are an important component of company law and regulation which provide information on shareholders accumulating shares in circumstances where they may either seek to influence or control a company or be motivated to take short term advantage in the market. These disclosures should enable companies and shareholders to see movements in shares prior to a particular investor either obtaining possible influence over the company or seeking to benefit from pressures in the market, e.g. around rights issues and other transactions. We consider the existing rules on disclosure of material stakes and the Companies Act thresholds (i.e. 3% and 1% thereafter) to be appropriate. We also support effective disclosure of other economic interests, although there is some question about whether delta adjusted disclosure of other economic interests is really meaningful in understanding the dynamics, incentives and motivations of participants in the market. However, the main disclosure thresholds only apply to UK incorporated issuers whose home state is the UK and not to non-UK issuers (third country issuers) whose home state is the UK. We share the view that the FSA should apply these requirements to non-UK issuers for whom the FSA is the home competent authority, as opposed to limiting the requirements to the TOD minimum.

7.3 Looking at the question of whether and how asset managers should be more transparent, we quite understand the concerns around, for example, some fee structures.[88] This is broad area is one that we are generally interested in seeing explored and debated further. In addition to the

84 See for example "The Concept of Investment Efficiency and its Application to Investment Management Structures" (2000) Hodgson et al.
85 "Rights Issue Fees Inquiry" (2010) - http://www.iicomm.org/docs/rifireport.pdf
86 See for example "M&A Advisory Fees and Analyst Conflicts of Interest" (2009) Becher and Juergens
87 See for example "Are fairness opinions fair? The case of mergers and acquisitions" (2009) Kisgen et al..
88 "Fund Management Fees" (2010) Terry Smith (http://www.terrysmithblog.com/straight-talking/2010/09/fund-management-fees.html)

work we reference in our answer to Q.6 on incentives, in terms of transparency, we currently have an internal project in hand looking at how accountability and transparency to clients might be enhanced and the challenges and normal market practices that would need to be addressed in moving practice forward. We would be happy to discuss these issues and the dynamics that exist further, if that would be of interest.

7.4 At a general level, the majority of Requests for Proposals (RFPs) prepared by investment consultants now contain questions on the extent of the asset managers' engagement with companies and thus do reflect the best practice framework. The extent of follow through on that does, however, vary with only a limited number of firms having developed significant expertise in this areas[89] and practice/views amongst individual consultants appearing to vary considerably. However, this is best considered in light of the views expressed by investment consultants and their clients and we note that the 2007 survey undertaken by the International Centre for Pension Management (see our answer to Q.6) offered an insight into the broad level of support amongst consultants across a range of issues relevant to this review.

7.5 On a slightly different tack, the recent report produced by Mercer's on the development of international norms, codes, and conventions relevant to responsible investment, not only highlights the breadth of interest that can be taken by consultants, over and above assessing and monitoring individual fund managers' practices, but also highlighted the inadequate involvement by investors as stakeholders in emerging global governance structures.[90]

8. 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.

8.1 Building on the points we note in paragraph 6.8 to 6.10 above, time and resource constraints can have an effect on the ability to and quality of engagement. We discussed the dynamics of stewardship and engagement in more detail in our response to the BIS consultation on "A Long-term Focus for Corporate Britain". There are good examples of engagement and collaboration, but there are equally cases and areas where it has been less effective than might have been hoped.

8.2 If fund manager activity in this area is to develop significantly then the selection, mandating and monitoring of fund managers will need to change as well. As has been noted, "Among the lessons from the recent market crisis is the interconnected nature of the challenges we face, and that we can no longer afford myopic responses. This reality has material implications for pension fund trustees and managers. The time has come for them to lead rather than be dragged along".[91]

8.3 Given the dynamics highlighted in our responses to Q.9 and Q.10 (ownership levels, portfolio turnover, shifts in asset allocation and global trends in the capital markets), this will be particularly important if a sustainable long-term dynamic is to develop. The changes being seen are impacting co-operation between investors, for example, in leveraging the exercise of voting rights and effective engagement with companies.

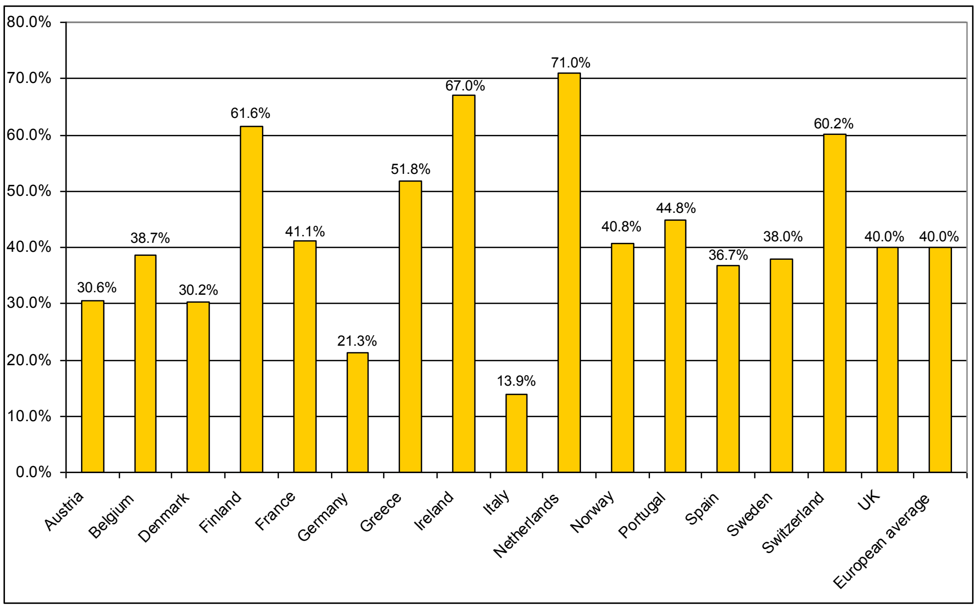
8.4 In terms of the dynamic, the true tests of its quality will need to be measured in terms of asset owners and managers being able to evidence that this is effectively integrated into their investment process and decision making and that it is being appropriately resourced and focussed on substantive risks.

[89] See for example: http://www.mercer.com/referencecontent.htm?idContent=1397000
[90] "International Codes and Conventions: Are Pension Funds Missing in Action?" (2011) J.Ambachtsheer
[91] "Defeating Short-Termism: Why Pension Funds Must Lead" (2009) Edward Waitzer, Rotman International Journal of Pension Management

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.

9.1 By way of context to the dynamics we have discussed above, we believe that it is important for the review to consider the implications arising from the fact that globalisation and capital market liberalization has resulted in increasing levels of foreign investment in domestic capital markets, not just in the UK but across European markets. This has naturally impacted on the relationship and engagement between shareholders and companies. It has also highlighted the growing influence of some proxy advisory services in influencing/swinging the US vote at UK company shareholder meetings.

Level of Foreign ownership across key European markets



Source: FESE data (December 2008)

9.2 At a macro level, international capital flows exhibit low persistency and their volatility has increased over time.[92] Notwithstanding the benefits of financial globalization, the recent literature stresses its associated risks[93] and also highlights the importance of deep and liquid domestic financial markets[94], greater exchange rate flexibility and prudential regulation[95], fiscal restraint[96], and strong institutions[97] to reduce these risks. Not least it will also be important to ensure the relative attractiveness of long term equity investment in the UK.

9.3 The Bank of England's Andrew Haldane has highlighted[98] the sharp decline in average holding periods for UK equities since the mid-60s to a period of just 7½ months in 2007 (See Figure 3), a trend that is reflected in the US and other international equity markets. This is another reflection of the shorter-term dynamic that is prevailing in the capital markets.

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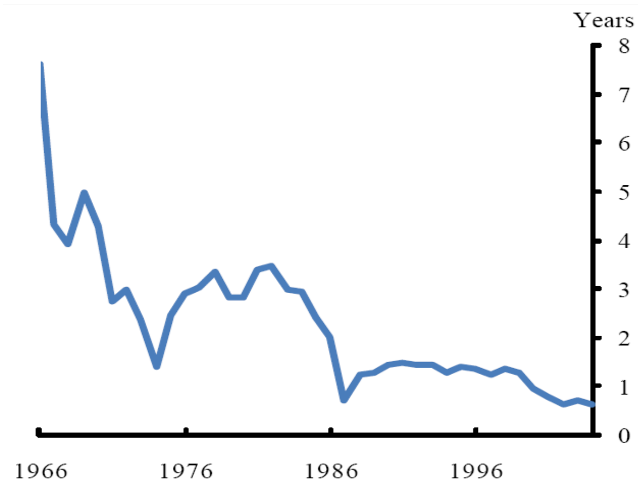
92 See, for example, paragraph 2.5 above
93 "Financial Globalization: A Reappraisal" (2006) Kose et al
94 Discussed in "Global Financial Stability Report – Financial market Turbulence: causes, consequences and Policies" (Oct 2007), IMF
95 "Global Financial Stability Report - Meeting New Challenges to Stability and Building a Safer System" (April 2010), IMF
96 "World Economic Outlook – Globalization and Inequality" (Oct 2007), IMF
97 "What drives international financial flows? Politics, institutions and other determinants" (2009) E.Papaioannou
98 "Patience and Finance" (September 2010), Bank of England

Figure 3. FTSE Average Holding Periods 1966-2005



Source: London Stock Exchange

9.4 However, the 7½ month figure does not offer a clear insight into the current state of play. Data from Tabb Group, UK National Statistics and the London Stock Exchange, shows that about two thirds of the turnover in UK equities is accounted for by hedge funds and high-frequency traders. By contrast the average holding periods of more traditional long-only funds in the past decade, who hold a more significant proportion of assets, have varied from 29 to 46 months, although this is still less than it was in the mid-60s.

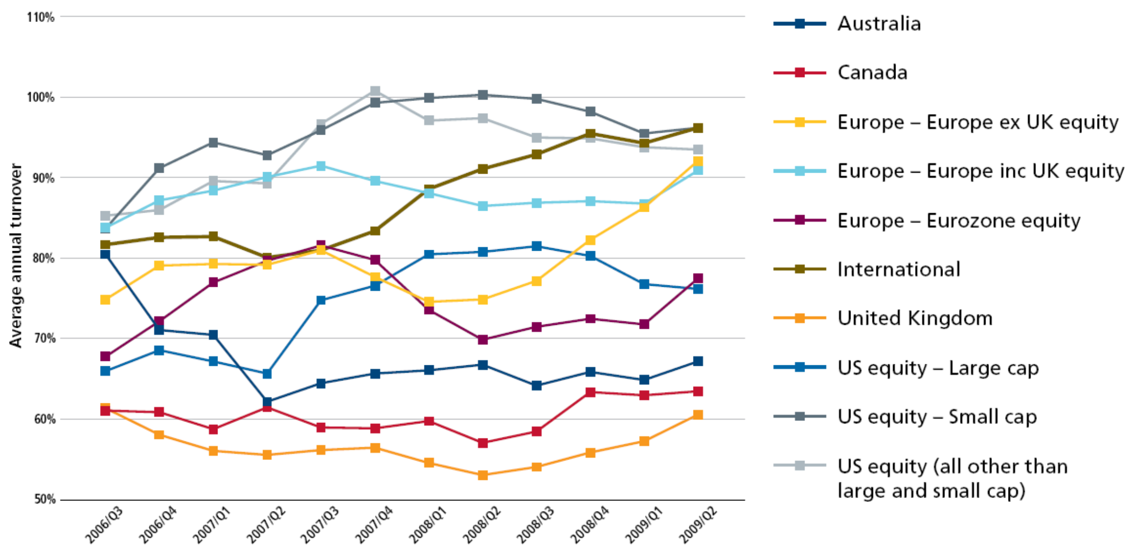
9.5 In the context of this review, another way to look at this issue is to consider portfolio turnover rates, which can vary considerable dependent not just on the style and type of fund (quant vs active vs index) but also depending on individual fund managers and mandates. In a report published last year looking at over 900 institutional actively managed equity portfolios, from June 2006 to June 2009, across all major regions and styles including value, growth, small, large cap and socially responsible investment (SRI) strategies, the authors found that turnover levels ranged from 10.8% to 253.9%.[99]

9.6 It is notable that the UK had the lowest average turnover by region, at 56.3% over the period, compared to the overall average of 72% and that, from a style perspective (across the full sample), value and SRI styles had the lowest turnover rates (59.1% and 59.2%) on average.

9.7 The chart below shows the average turnover rates by region but, underlying that, the ranges in each case still remain wide.

[99] "Investment Horizons: Do managers do what they say?" (2010) IRRC Institute and Mercer

Average annual turnover by region over time within the entire sample



Source: IRRC Institute and Mercer

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.

10.1 Global trends, both in terms of asset allocation and the development of capital markets internationally provide important context for the debate around the short vs long term orientation of the capital markets dynamic in the UK. We believe that these emphasize the importance of not just looking at the effects and issues of the short term dynamics that have become so prevalent, but also to look at the relative attraction of providing long-term equity risk capital to UK companies.

10.2 UK asset owners, like their international counterparts, are increasingly diversifying their portfolios internationally and away from equities. The developments seen in asset allocation as the field has developed, have further to go and will increasingly have a long-term, forward looking orientation inherent in them. With better long-term growth prospects in emerging economies and their small share of major institutional investors' overall portfolios, as a trend, strong portfolio flows to emerging economies should persist for the foreseeable future.

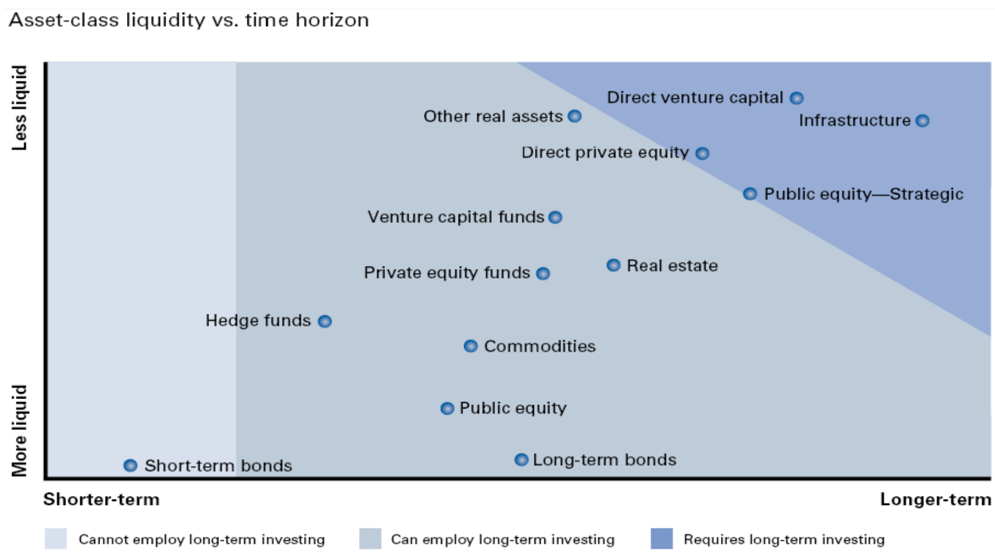
10.3 Extensive research carried out since the 1980s by US academics such as John Campbell, Eugene Fama, Kenneth French and John Cochrane have challenged Samuelson's 1965 efficient markets hypothesis (in which he argued that successive price changes are independent over time and returns at any investment horizon are unpredictable) and provide support for the notion of long horizon predictability. Essentially they have found that, whilst it is difficult to find systematic patterns to predict the direction of market in the short-term (e.g. one year), results are much more promising when it comes to anticipate shifts in the long-run direction of asset returns.

10.4 However, some traditional asset allocation models (e.g. using mean variance) can adopt too short-term a view of risk and return and may not effectively address risk appetite and horizons, which can lead to sub-optimal allocations for some. As matters stand, pension fund trustees and fiduciary managers will increasingly need to look to enhance asset allocation practices and apply more forward looking, dynamic asset allocation to pension fund portfolios. This is a significant issue and one we have been exploring and analysing internally and we would be happy to share that work with the review team.[100]

[100] http://www.avivainvestors.co.uk/media-centre/2011-archive/xml_027201.html

10.5 In practical terms, as Mercer's 2011 Asset Allocation Survey[101] highlights, UK pension plan allocations to corporate equity still stand at around 47%, but that is down from around 74% in 2000. In addition, the majority of that, or 26% of the total asset allocation, is to non-domestic equity. In contrast to that, Towers Watson has highlighted[102] that the US market remains the most committed to domestic equities (70% of their equity allocations, which run at around 49% of the total). That said, across the markets they examined, over the last 15 years, equities, bonds and cash allocations have all been reduced to varying degrees, as pension funds have diversified into others assets classes, including real estate, private equity and hedge funds. Those asset classes saw their weightings increase from around 5% to 19% over that period.

10.6 Of course, investment diversification does not, of itself, imply short-termism, as the figure below illustrates in terms of the time horizons and liquidity of alternative asset classes. That said, one effect of the shift away from equity by long-term capital, will be to increase the effects and impact of short-termism in the equity market. That points to the need for policymakers to consider the relative attractiveness of long-term equity commitment rather than just focus on short-termism.

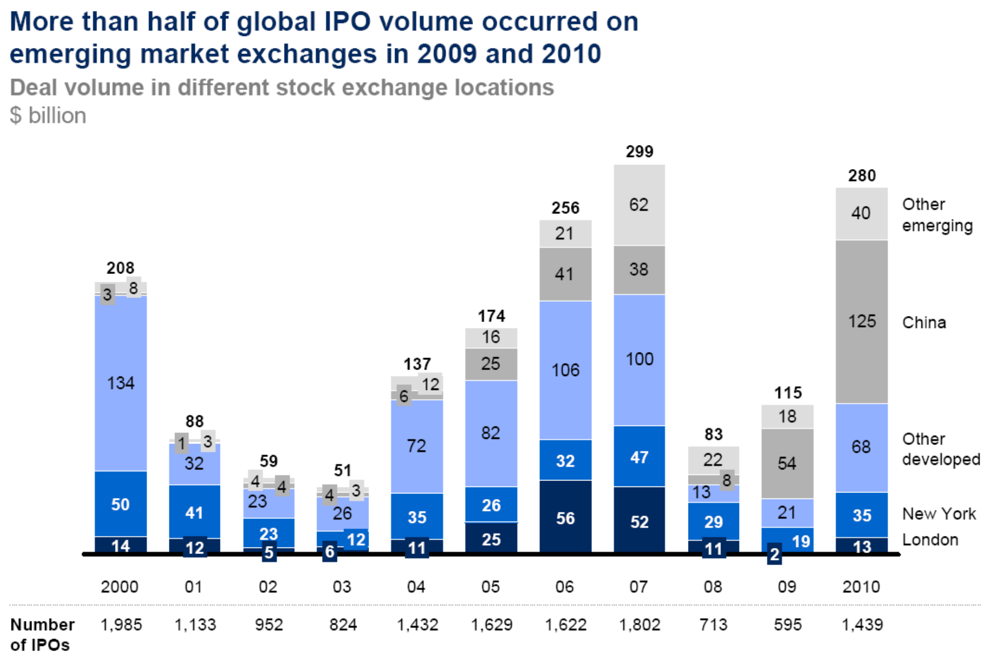


Source: "The Future of Long-term investing" (2011), World Economic Forum

10.7 With asset allocation decisions of investors at the core of financial flows between markets, currencies, and countries, this trends comes as the fall in UK investment from 1980 through 2008 has reached the equivalent of a $20 trillion reduction from a stable investment rate.[103] As the McKinsey Global Institute has pointed out, that effective fall in the 'demand' for capital is an often overlooked contributor to the three-decade-long fall in real interest rates that helped feed the global credit bubble. It also provides a backdrop for future growth in global investment that will ultimately be driven by emerging markets and it is notable that, alongside the growth in the issuance of emerging market equities, the development of stock exchanges in those economies has gathered pace, and they are increasingly becoming important venues for raising and investing capital. This further emphasises the need for policymakers to take account of these trends in considering the issues around short/long term investment in the UK.

10.8 To add context to that, while IPOs on emerging market exchanges totalled just $11 billion in 2000, by 2007 that number had increased to $100 billion and by 2010 it had reached $165 billion, exceeding initial public offerings on developed countries' stock exchanges.[104]

[101] "European Institutional Marketplace Overview 2011" Mercer
[102] "Global Pension Asset Survey 2011", Towers Watson
[103] "Farewell to cheap capital? The implications of long-term shifts in global investment and savings" (2010) McKinsey Global Institute.
[104] "Mapping global capital markets 2011" (Aug 2011) McKinsey



NOTE: Numbers may not sum due to rounding.
SOURCE: Dealogic; McKinsey Global Institute Analysis (Reproduced from "Mapping global capital markets 2011")

10.9 In effect, following the crisis, Hong Kong, Shenzhen, and Shanghai became rivals to London and New York for new listings, not just for emerging market firms but also for corporations headquartered in developed countries. For instance, in May Glencore listed its initial public offering, one of the largest ever for a European firm, in both London and Hong Kong. Prada listed its shares on the Hong Kong exchange in June. Meanwhile, Coca-Cola has begun exploring a listing in Shanghai. Firms around the world are listing in Asia to take advantage of ample capital and hungry investors.

10.10 As the IMF has indicated, notwithstanding the benefits of financial globalization, the recent literature stresses the associated risks and highlights the importance of deep and liquid domestic financial markets, amongst other things, in mitigating the risks on domestic economic and financial stability.[105]

10.11 Given these trends and the issues noted in our answer to Q.9, we believe that it is important for the review to consider not only issues of short-termism, but also the question of the broader attractiveness of long term equity investment in the UK.

David Lis
Head of Equities
Aviva Investors

Iain Richards
Regional Head of Corporate Governance
Aviva investors

[105] "Financial Globalization: A Reappraisal," (2006) Kose et al, IMF Working Paper 06/189

APPENDIX 1

A European Financial Transaction Tax

An FTT will be difficult to calibrate or target effectively and there is a very high risk that the FTT will fail to raise significant revenues of the kind envisaged. The Commission's estimated yield of €57 billion appears to be consistent with estimates for turnover in financial assets made by the Bank for International Settlements in 2007, however the reality will be entirely different. The commonly cited Swedish experience with FTTs provides a good example of what can happen:

- Equity share prices fell, as the market effectively sought to net out the incorporated the capitalized value of future FTT payments against future capital gains, this is certainly something that would happen here.

- Companies' cost of capital for companies rose (while it may seem counter intuitive, the impact could be more noticeable for companies with less liquid shares, i.e. smaller companies).

- Although bonds don't generally see the same volume of trading (with the FTT therefore having a lower impact) Sweden's Bond Markets were impaired with bond trading falling by around 85%, futures trading by 98% and the options trading market effectively disappeared.

- The Swedish Government's borrowing costs increased (exempting transactions with the central bank would largely be irrelevant, because investors would still factor in the secondary market costs).

- Mobile financial activities migrated from Sweden to non-taxed or lower-taxed jurisdictions (e.g. initially 60% of the trading volume of the 11 most actively traded Swedish share classes, accounting for one-half of all Swedish equity trading, moved to London, with trading more broadly following afterwards);

- Tax yields from the remaining Swedish activities were a fraction of those projected, both as a result of reduced activity in Sweden, migration to other markets and others action taken to net out the cost of the FTT (see my first bullet point). Even when the tax was doubled, in 1986, the revenue only by around 22%.

In some ways the UK experience would be worse than the Swedish one. The market would look to net out the cost as happened in Sweden, but the UK Government would then be losing on both sides of that as the FTT revenues would go to Europe. In other words it is very possible, even likely that UK would be fiscally worse off. It gets worse though. If you look at the pattern of transaction taxes and why they have been withdrawn or reduced over the last 30 or so years (US, Germany, Sweden, Japan, Australia, Italy, France etc) a key factor in the debates and decisions has been the concern about the impact on businesses' cost of capital and impairing the development and competitiveness of domestic financial markets (not least given the increasing cross-border mobility of capital). Some of the IMF work on the US (based on 2009 data) noted that a 10bps (i.e. 0.01%) transaction tax would increase companies cost of capital by about 25 bps. Looking at that the other way around, Oxera's work in 2007 estimated that the abolition of UK stamp duty would reduce companies cost of capital by between 66 and 80 bps.

Cost of capital is always a tricky thing, but to offer some context, looking at Europe Economics' Phase III report in March 2011 on the cost of capital for Ofgem's for future price controls, they put the cost of equity (before re-levering) at 6.725%, so a 25bps increase equates to a 3.7% increase. It's not a robust analysis, but for illustrative purposes, the FTSE 100 had an equity market capitalisation of £1,548,695m as at 30 June 2011, so just for those companies a 25bps increase might be taken to imply a notional increase in the cost of capital equivalent to £3.87bn (by contrast the 50bps stamp duty raised around £3billion last year).

The impact assessment accompanying the EU proposal recognises not only that it may lead to a significant relocation and 'disappearance' of activities and substantial hikes in the cost of capital, it notes that could result in a reduction of long-run economic growth in the EU by an estimated 1.8%, but that impact will not fall evenly between member States.

Established businesses, like insurers and banks, would be less able to avoid the tax and the consequential costs associated with it, including the increases in cost of capital that would ensue. More mobile tax payers such as securities dealers and hedge funds could simply move their operations to a tax haven, or use the various definitional and scope loopholes, as well as product innovation to avoid it.

That means that ultimately much of the cost would fall on (i) consumers rather than high net worth investors in hedge funds or financial institutions and (ii) the more traditional long term investors (looking at stamp duty (in 2006) it was estimated that only about 20% of share trading on the LSE was subject to stamp duty, and the tax burden tended to fall most heavily on longer term, risk-averse investors, such as insurers), who would also find that it was no longer economical to run liquidity and cash funds as part of an overall investment strategy.

So what might be done?

That depends on what 'they' are trying to achieve. If it's to generate revenue, look elsewhere, but recognise what collateral impacts any step might have. That said the dynamic does change if an FTT were really global. More practically though, if the intention is actually to address (abusive) high frequency trading, then there are other steps that could be considered. Just two of the alternatives that would merit consideration are:

(i) **a trade cancellation fee.** If you look at the tactics used by HFTs (smoking, spoofing, stuffing, linked trades where only one executes etc) then this would be much more targeted at the more troubling activity (we understand that something like 60% of trades on behalf of passive HFT's who market make in illiquid stocks are posted and cancelled in micro or milliseconds and, although this number reduces for liquidity-taking HFT, the number is still in excess of 45%).

(ii) **a minimum resting period** (something the Bank of England and EU have toyed with as an idea). Although this might have the effect of widening spreads, as long term investors we really don't see that as a significant problem. Those spreads are at such small sizes that they have little or no relevance to us or the prices we actually trade at and it would also contribute to curtailing the volatility HFTs create, which is an issue.

APPENDIX 2

Project Summary: Capital Markets Incentives and Sustainable Behaviour

Project overview

The purpose of this study is to undertake a detailed assessment of the impact of incentives in capital markets and the effect that these have on behaviours and decisions which lead to unsustainable outcomes – and to understand how they might instead be better structured to incentivise sustainable behaviours and outcomes.

Our shared conviction is that the financial system as it currently operates all too often allocates capital to activities that are unaccountable to citizens, and harmful to the environment, human rights and social equity, to the detriment of individuals as savers, investors and citizens, to businesses and to society.

The overall questions we are seeking to explore are:

- **Do capital markets currently allocate capital to corporate activity in a way that undermines sustainable development?**
- **What changes to personal incentives throughout the capital supply chain are needed to ensure the capital markets are better structured to incentivise sustainable business behaviour?**

Whilst we will take a system level approach it is our contention that it is impossible to accurately understand what is happening now and what needs to be done without first examining the roles, incentives (both hard and soft) and mindset of the individual players within the system at a granular level.

We are clear that such a study is of vital importance and that it has not as yet been undertaken – some studies have taken a high level overview, others have identified particular issues and explored them in depth, none have combined these two approaches with sufficient breadth and depth in a way which is fit for purpose.

The report will outline key points of leverage for intervention and a high level policy framework for achieving change set in the context of the opportunity and imperative provided by Rio +20 including the UN Secretary-General's High Level Global Panel on Sustainability, and also the Kay Review in the UK and other key developments in the EU and elsewhere.

Given the differences in regulation, culture and remuneration practices in various geographical regions, our primary focus will be on the equity markets within an Anglo-Saxon context to develop a set of detailed recommendations for change. An initial scoping of the differences in some key regions may be undertaken to assist in testing the relevance of the final recommendations. We aim to build on this study to assess the full implications of our findings for other markets.

We will generate interest and momentum for this change through a launch event and other public events, and a programme of advocacy and engagement with key individuals and organisations.

We will reinforce the impact of this activity by leveraging other relevant Tomorrow's Company activities and programmes - in particular the Good Governance Forum, setting out what this means for boardrooms and exploring the wider agenda for corporate governance which will follow from these findings, and our high profile and influential Stewardship campaign.

Timescale

We are aiming to finalise the report at the end of Q1 2012 with interim policy recommendations being developed to take full advantage of key opportunities for policy influencing.

This will then be followed by a programme of communications and advocacy as outlined above.

Subject to funding we will also undertake further 'deep dives' whilst also testing our conclusions in the context of other regions and markets.

Context and opportunity

The recent financial crisis and consequent changes in societal expectations are prompting calls for change in the behaviour of companies and the behaviour of the capital markets that support them. For example:

- Sovereign wealth funds and other long-term investors are increasingly recognised as uniquely placed to deploy long-term investment strategies to help find solutions to the social and environmental crises that we are facing. Their mandates and their global reach provide them with the necessary motivations to do so.
- The UN Principles for Responsible Investment now has over 870 signatories representing more than US$ 25 trillion of assets under management. In November 2010, 259 investors – both asset owners and asset managers – collectively representing over US$15 trillion of assets – signed up to the 'Global Investor Statement on Climate Change: Reducing Risks, Seizing Opportunities & Closing the Climate Investment Gap'.
- Aviva Investors report that 89% of new business 'requests for proposals' and 'requests for information' asked about ESEG issues (on average raising 6 and a half questions) between Q1 08 to Q3 2010
- Certain territories are reviewing the adequacy and nature of reported information around climate change, resource usage and population growth. For example, in February 2010 South African listings requirements were amended to force compliance (or explain why not) with the King III Integrated Report Disclosure Checklist. In Denmark, the Danish Financial Statements Act (2008) required the 1100 biggest companies in Denmark to account for their work on CSR in their annual reports from January 1 2009.
- The IIRC has been created to respond to the need for a concise, clear, comprehensive and comparable integrated reporting framework to support the information needs of long-term investors and make clear the link between sustainability and economic value.
- In the UK, the Stewardship Code aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities.

These examples, among others, form an emerging and important patchwork of interventions and change. However, the whole is not yet greater than the sum of the parts.

This project will support the current community of interest, deepen dialogue and help realise the full potential of this emerging agenda for change by bringing the various elements together to form a coherent framework of action.