HOUSE OF COMMONS

ORAL EVIDENCE

TAKEN BEFORE THE

BUSINESS, INNOVATION AND SKILLS COMMITTEE

THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING

TUESDAY 5 MARCH 2013

ANITA SKIPPER, STEVE WAYGOOD, NEIL WOODFORD AND CHRIS HITCHEN

DANIEL GODFREY, GUY SEARS, PENNY SHEPHERD AND MATTHEW FELL

Evidence heard in Public Questions 181 - 282

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Oral Evidence

Taken before the Business, Innovation and Skills Committee

on Tuesday 5 March 2013

Members present:

Mr Adrian Bailey (Chair)
Mr Brian Binley
Paul Blomfield
Katy Clark
Caroline Dinenage
Julie Elliott
Rebecca Harris
Nadhim Zahawi

Examination of Witnesses

Witnesses: **Anita Skipper**, Corporate Governance Adviser, Aviva Investors, **Steve Waygood**, Chief Responsible Investment Officer, Aviva Investors, **Neil Woodford**, Head of UK Equities, Invesco Perpetual, and **Chris Hitchen**, Member of Kay Advisory Board Team and Chief Executive, Railpen, gave evidence.

Q181 Chair: Good morning. Thank you for agreeing to help the Committee with its inquiry into the Kay Review. I will start by asking you to introduce yourselves for voice transcription purposes. Can we start with you, Anita?

Anita Skipper: I am Anita Skipper, and I am the Corporate Governance Adviser at Aviva Investors.

Steve Waygood: Good morning. I am Steve Waygood, the Chief Responsible Investment Officer at Aviva Investors.

Chris Hitchen: I am Chris Hitchen, and I am Chief Executive of the Railways Pension Trustee Company. I served on the Advisory Board for the Kay Review.

Neil Woodford: I am Neil Woodford. I am a fund manager at Invesco Perpetual. I have worked for the same company for 25 years, running the same funds for most of that period.

Q182 Chair: Before we start the actual questions, I should say that we have a lot of questions and not much time to get through them. Some questions will be for the whole panel, but do not feel obliged to contribute if you feel that the previous speaker has covered any points that you wished to make. Obviously, if you have something to add to or subtract from what has previously been said, feel free to do so. Brevity is much appreciated.

I will start by going back to Lord Myners, and this is a question for the whole panel. When he did his report 10 years ago, he called the intermediary regime too complex, but so little has happened since then that Professor Kay stated that the "chain of intermediation should be shortened". Why do you think the industry ignored Myners's initial call for simplicity? What lessons do you think we should take from it? Who would wish to lead on that?

Anita Skipper: One of the reasons is that pension funds had a lot of other issues to deal with over that time—their own deficits and the governance of their own teams—and so the stewardship stuff came down the agenda. I think it stayed there because the economy and the issues for pension funds have been so great. Also, part of the reason is that pension fund trustees are not always experts on these issues, and the intermediary chain has increased because they need to get advice, they need to be confident that what they are doing is right and, if they are not, they need to employ people who can advise them.

Q183 Chair: You are saying that basically it just was not high enough on their list of priorities, and I think the issue of the lack of understanding of pension fund trustees is well understood. Is there any other member who would wish to add to or subtract from that? Chris Hitchen?

Chris Hitchen: I would substantially agree with what Anita said, but I would say that large pension funds have done a lot over the last 10 years to take control of their intermediary relationships, bearing in mind that they were only part of the whole picture. Certainly Kay in his report was very aware of the fact that it was not just about large pension funds or even pension funds in general; it was about all investing, and clearly there are many investors who are not represented at all. He was trying to find mechanisms that worked for the market as a whole.

Q184 Chair: That is an important point, because whilst it may be possible to argue that the pension fund managers had a specific set of problems that they may have prioritised, that is not really true of the industry as a whole, because they did not have quite the same set of problems. Did they just not take it seriously enough?

Chris Hitchen: Speaking for my own fund and for the pension fund industry generally, we took the Myners report extremely seriously. As I said, in many ways trustees have upped their game over the last 10 years.

Anita is absolutely right: this has not been an easy decade for institutional investors generally, but for DB pension funds in particular we have had to contend with rising deficits, closing schemes, employers that can no longer afford to pay—all those kinds of things. These are big issues, and there have been secular shifts in the way institutional investing is organised in the UK. We are in a bit of an interregnum. I happen to run an open DB fund but there are not many of us left. There is going to be a new world of defined contribution schemes, which auto-enrolment is going to empower.

Chair: I agree with at least half of that statement; it has not been an easy decade for investors, but an awful lot of people have done very well out of it. I will perhaps try to focus.

Chris Hitchen: I would agree with that, too.

Q185 Chair: You have partly anticipated my next question, which was: has there been any strengthening or hardening of the regulation of the institutional investors? You have said the pension fund trustees have upped their game. What progress has been made, if any? I am quite happy to take a contribution from anybody, but, Chris, do you wish to elaborate on what you said previously?

Chris Hitchen: In the context of the interaction with UK companies, I would say that more investors are fully engaged than was the case 10 years ago and the extent of that engagement is much deeper. We have seen developments in stewardship codes, and we have seen more and more commercial asset managers getting involved, partly due to their clients asking them to do so.

Anita Skipper: I would not quite agree with that because, bar a few exceptions like Railpen, USS and a few of the large commercial ones, our experience is that many pension funds do not prioritise this at all. In fact, some today do not even know what the Stewardship

Code is. There have been improvements with some of the larger funds, but a majority of them still do not even know what this whole issue is about.

Q186 Chair: It is a point made by FairPensions, PIRC and others: whilst some are aware and have signed up to the Stewardship Code, plenty have not, and for some of those that have, it is a pretty tick-box exercise. Steve, you wanted to come in?

Steve Waygood: Yes. Thank you, Chair. Your question was about the progress we have seen in the industry over the last, say, decade or so. If I think about the system, and I know that Professor Kay was looking for a systemic response to the problem of short-termism, there has been a lot more work in the area of stewardship or corporate governance by some of the sell-side brokers. There has been more work by consultants, and I would particularly point to Mercer and Towers Watson as doing reasonably good work in the area of analysing corporate governance and stewardship by buy-side fund managers.

Can I share some data that we have done at Aviva Investors? We have analysed three years' worth of the signals that we get from the market: the requests for proposals; the requests for information; and due diligence questionnaires. Some 89% of those requests for information ask questions relating to, "How do we behave as good stewards?" If I think back over the last 10 years, that is a significant transformation in the demand that at least some schemes are putting into their tendering process.

However, we cannot see how heavily that is weighed, and after take-on, with some notable exceptions, the vast majority of schemes do not raise questions regarding stewardship after we have become their fund manager. In other words, what I believe is that, whilst there is a significant number of questions now in these requests for information, it is almost a housekeeping exercise. It is not treated substantively importantly.

Q187 Chair: That is important. You said initially the requests that came from the market; are you talking about basically pension fund trustees? Who else might that include?

Steve Waygood: Our institutional clients, so, yes, you could consider them to be that, or foundations—institutional investors that come to us looking for a segregated mandate. We have analysed over 1,000 types of those different questionnaires that have come to us, so it is a meaningful piece of work. The average number of questions per questionnaire is six and a half, so broadly 10% of each questionnaire covers this area.

However, as I say, we cannot see how heavily it is weighted in the final decision, and our experience is that it is not heavily weighted in the final decision. But that is experience; it is not knowledge. Also, after we have been secured as the fund manager, there are literally only a handful of schemes that hold us to account for delivery of stewardship in a substantive way. In other words, demand is missing and, as an observation on the Kay Review, what he focuses on is supply—supply of more stewardship. I do not think there is very much in there that will lead to increased demand for stewardship and an informed oversight environment.

Q188 Chair: Could you very briefly outline how that demand could be increased?

Steve Waygood: With pleasure. The entire system has a role to play. Trustees should be very transparent with pension beneficiaries about what stewardship has taken place, and there could be a requirement for that to happen. Pension schemes should also be required to embrace the Stewardship Code, and comply or explain. Investment consultants have, I believe, an obligation, a duty of care, to scrutinise fund manager performance in this area and proactively raise it into the discussion with their clients.

At the moment, my understanding, based on some evidence, is that investment consultants—who are centrally important in the UK fund manager selection environment; I cannot overemphasise their importance—very seldom proactively raise this area in their advisory environment. They could and should be required to do that. Fund managers, for our part, should be more transparent with their voting record collectively as an industry, and there are other reports that we could be producing. I could carry on, but you asked me to be brief.

Q189 Chair: I think we got the gist. The next obvious question is: how could you enforce or change that environment without intrusive regulation? Do you think the investors' forum that is being proposed would have a role?

Chris Hitchen: I think it could. It is certainly something that we debated extensively in the Advisory Board. It is not as if it has not been tried before. I have even been involved in some previous attempts to provide an umbrella where investors can come together.

I think what Kay had in mind was something very specific: where there is an issue of the day with a particular company, there should be a safe place where all investors with a legitimate interest could gather together to discuss that and not worry about whether they are going to be seen as part of a concert party, or whatever it might be, because there was some implicit, if not explicit, Government backing for the endeavour.

We recognised that it was very important that we did not just capture large pension funds or the big asset managers who operated for them. It was important to have everyone in the tent. Bear in mind that, of the £18 billion fund that I run, I should think less than 10% of it is invested in UK equities today. There are many international investors operating in a very significant way in the UK market. They all need to be brought into the same tent, and it was really an attempt to try to create that.

Q190 Chair: Can I move on? One of the things that emerged from our previous panels and questioning so far has been the nature of fund management and its disconnect from the companies whose shares they manage, largely because they have so many. When we questioned Myners, he questioned this idea that fund managers should talk about company strategy or be more closely involved with the individual company strategy. His line was: "Most fund managers have not done anything other than work in the City. They have never run a business," and I presume that he is assuming that they do not really understand business anyway. What is your view on that? Anita, you are smiling. Do you want to lead on that then?

Anita Skipper: I was just looking at the fund manager. In our little group of fund managers, we actually do have fund managers who have run businesses themselves. The role of the institutional investor is to challenge the strategy that companies have put forward. Then we can decide for ourselves whether or not we believe it, and whether or not we will put money towards it.

Q191 Chair: Isn't that more easily done if the fund manager has been in a business and basically knows what it is all about?

Neil Woodford: Not at all. No, I do not believe so. I do not believe our role as fund managers is to tell companies how to run their businesses. We are there to hold their feet to the fire on things like capital allocation and strategy. In some respects, having run a business might be a disadvantage. That may sound a little odd, but the fact is that the interaction between a company and its shareholders should be based around holding management to account with respect to the shareholder agenda, and making sure that the board behaves appropriately with respect to its shareholders and particularly with respect to capital allocation. Essentially, fund managers are capital allocators; that is what our expertise should be focused on. That is where I think there is a deficit of understanding on boards. Capital allocation tends to be the issue on which we engage most actively with companies.

We are not experts in how to extract more working capital or where to cut costs or where to invest in terms of the micro-management of the business, and I think that would be counter-productive. Boards would become dysfunctional if all their fund managers were trying to chip in and tell them how to run their business. We are not trying to do that; we are taking a step back from that and operating at a higher level.

Chair: Brian Binley wanted to come in with a supplementary; he, of course, has run a business.

Q192 Mr Binley: And I have founded two. I might be very annoyed if fund managers tried to tell me how to run my business when some of the records suggest they cannot run their own business. That would concern me. Isn't there a very fine line between the sort of scenario you paint, and going slightly further and being involved in the prime decision-making of a given company with regard to the important issues that you are not equipped to be involved in? Isn't there a fine line and isn't there a tendency on occasions to go over that line?

Neil Woodford: It depends whether you behave like an owner or a trader, frankly. As a fund manager, my average holding period has recently been as high as 16 years. At the moment it is a bit below that but it is certainly above 12 to 13. You can imagine that, when you have that sort of relationship with a business and you are typically holding a business for that period of time, you probably see three chief executives come and go during that average holding period and you see the board turn over many times. So you are the longevity in that sort of relationship, not the board or the executive.

You can imagine in that sort of relationship, where you are a long-term shareholder, you are engaging with a company principally on strategy and capital allocation. In those sorts of situations, we think it is our responsibility to engage with that company, and to give our advice and ha'penny worth on how they should allocate capital.

Q193 Mr Binley: You did not quite answer my question, so I will press you a little further. The truth of the matter is doesn't Kay—and, by implication, Lord Myners—think that big pension fund holders are too involved in the direction of business? Isn't that the question he is really asking?

Neil Woodford: No, I do not think so. I do not read it like that.

Q194 Mr Binley: Having talked to him, I do think so. Let us accept that as a starting base. If that is the case, isn't that a dangerous situation, where the imbalance between the big fund holders and other shareholders is out of balance?

Neil Woodford: I can envisage a situation where, if fund managers or asset managers were disproportionately empowered to intervene or felt that their responsibility was to intervene in the day-to-day management of the business, that would create an imbalance in the relationship between the owner and manager, and would create confusion. The problem that I see today is the complete opposite, in that most fund management groups really do not behave like owners; they do not think like owners. If something goes wrong at a business, or if something happens in that business that they have not anticipated or the share price underperforms for a quarter, as Kay emphasises, they emphasise sale over voice. You have got to have a long-term perspective to emphasise voice over sale.

My view is that the problem is the complete reverse: there is not enough engagement. Institutional shareholders do not take enough of an interest in the strategic direction of a business. There might be quite a lot of engagement over executive remuneration or non-executive director RemCos, etc., but to my mind the lack of involvement principally focuses on that sort of engagement around strategy and capital allocation.

Q195 Chair: I just want to come to a couple of quick questions. We have been on this theme for some time. This is to you, Neil, because in your *Policy on Corporate Governance and Stewardship*, you state that you will only "vote on shares listed outside of the UK, Europe and the US by exception". Why is that?

Neil Woodford: I do not know, to be honest. I am a UK fund manager, although I hold shares in companies quoted in other markets in my funds. I run about £32 billion and about 20% of that is invested in businesses quoted on other markets. We do vote those shares. I am not responsible for the other fund managers in the other parts of the organisation. I read my Stewardship Code the other day and thought it was a worthy document, but the problem is not really in the documentation or in the policy; it is actually in the implementation.

Chris Hitchen: At the Railways Pension Fund, we do vote our shares around the world, and we have a small team that works really hard to make that happen. We also partner with other institutional investors around the world to make it happen. It is not a costless exercise by any means. It is really quite difficult to do it properly, and especially if you are going to engage with the companies as well, so there does need to be enough resource put behind it.

Anita Skipper: Yes, that is important.

Q196 Chair: To a layperson it would seem that, if a fund had a strategy for investment, it would exercise that strategy consistently with both UK and other companies. It seems a little odd. My next question was going to be: is this typical of other companies? From what you said, Chris, it is not necessarily typical.

Chris Hitchen: It is not typical of our fund and a number of other funds.

Q197 Chair: What is the view of the industry in general?

Steve Waygood: I can certainly agree with everything Chris has said—and, for that matter, Neil. We vote our shares on the MSCI World Index very actively. One reason why other fund managers do it less might be because of asset allocation decisions in our UK market. We tend to run a lot of UK equities, and as a consequence of that you will own more of a company in the UK than you would of a company in, say, Japan—or France for that matter. Therefore, if you own less of it, your return on your stewardship engagement will be lower and your ability to influence the company will be lower.

You should regard our industry also as one that is resource limited. We need to focus our resources on those areas where it is going to provide the greatest return to our clients, and that often means companies where we have got the biggest investments in market cap terms.

Q198 Chair: Again you have partially anticipated my next question: how much of a burden would it be? I will bring you in in a second, Neil. In effect, the more companies that you invest in, the greater the potential burden if you wish to scrutinise them closely. Of course the more foreign companies, I would guess, the greater the running costs. From the nodding of your heads, is that a reasonable observation?

Chris Hitchen: Yes.

Neil Woodford: There can be a disproportionate focus on voting as representative of your corporate engagement. In the environment that I experience day to day in the UK, corporate engagement is a bit like an iceberg. The bit that you can see above the surface is your voting record, but the vast bulk of your engagement is actually below the surface. It is not obvious how you engage or when you are engaging.

Typically, when we get to the point where we are abstaining or voting against various corporate executives, that tends to be the surfacing of legacy issues that we might have been debating with a company for maybe years. It would be wrong to correlate a voting record necessarily with your level of corporate engagement. Lots of people vote but do not say or do any corporate engagement.

Q199 Chair: I would certainly accept that observation, but to turn it round the other way, it seems odd, if you were engaging, that you did not actually exercise your vote.

Neil Woodford: Indeed. I agree with that, yes.

Q200 Chair: So, on the surface, there is an awful lot of non-engagement in companies that substantial funds are invested in?

Chris Hitchen: Chairman, I think Professor Kay would agree with your premise that many fund managers are over-diversified, effectively, and it limits their effectiveness in engaging. I would say that Neil is an honourable exception in that. Kay's proposal to deal with that was that fund managers should have much more conviction, hold smaller portfolios and be much more prepared to deviate from market benchmarks. That of course requires us as customers to set them benchmarks that are more appropriate for a long-term approach. I think he envisaged a market place that was bifurcated between very active investors and effectively an index-tail to mop up the rest of the institutional assets. It is very important that we have proper stewardship of those passive assets as well.

One technical issue is that, to the extent that even large funds like ours invest through pooled vehicles, whether passive or not, it is sometimes hard to get the fund managers of those pooled vehicles to give you your share of the ownership rights and to vote in the way that you would wish. One thing that Government could think about would be more than polite encouragement of fund managers to do that.

Q201 Rebecca Harris: We spoke last week to four representatives of the fund management industry who all seemed to have quite commendably high levels of exercising their voting rights, but not one of them actually consulted their clients on how they wanted them to vote. How typical do you think that is of the industry generally?

Steve Waygood: When one tries to do that, clients often tell you—but by no means all of them—that they have got other priorities on their mind, and this area is extremely complicated. If, for example, we were to bring them our Stewardship Code or our corporate governance policy and explain in detail how we vote, that would take a good few hours of a trustee meeting, and it is generally, typically, not something they are willing to invest the time in. They will delegate it to us. They will expect us to report back to them on what we have done in our quarterly reporting.

Again, I mentioned earlier the lack of interest post take-on, post us running the funds, and with the honourable exceptions excluded, I can count on one hand the number of questions over the last 15 years I have had on the content of the stewardship section in the investor report that we give our clients. It is a problem of time being allocated by clients to this area, but by no means all of them.

Neil Woodford: In my organisation, and certainly within my area of responsibility, I have hundreds of thousands of clients—individual savers through ISAs and investment products—and it is not possible to engage with them to evaluate what they would like me to do specifically on each individual issue. I make a point of expressing to their representatives, the IFAs and the interactions I have with their representatives, how important I think corporate engagement is, and I think my track record speaks for itself on that front.

Unfortunately, it is impossible for us, or me specifically, to get a clear view of exactly what they want me to do on each specific issue and in generality even. I think the overwhelming desire is for fund managers to take ownership responsibilities seriously. That must be a given, and I assume it to be a given, amongst my investor base, and I take that seriously.

Chris Hitchen: I think the challenge for Government might be how to construct stronger governance models to represent investors. We keep going back to large pension funds, where the trustee model arguably does provide some level of oversight and governance, and you are saying it is weaker further down the chain.

We have a lot of subscale pension funds in the UK, but we also have hundreds of thousands of other representative retail investors, as you say. I am involved with an initiative called Pensions Quality Mark, which is trying to build good governance into the new defined contribution schemes that are coming up, but arguably we need something even broader that would cover Neil's clients as well.

Anita Skipper: Something that one of our fund managers suggested was that, if you have retail clients, you should have a "meet the fund manager" once a year. So if you are running unit trusts where you have lots and lots of investors, you could have a day like an AGM that companies have but you would actually have the fund manager there, who will answer questions from any interested individual who might want to turn up and find out how you are running the fund for them.

Chair: That is a very interesting suggestion.

Q202 Nadhim Zahawi: Just picking up on Neil Woodford's point, explain to me why it is impossible for you to engage with them.

Neil Woodford: Kay talks about disintermediation and the complex chain that exists between saver and company. The fact is that our relationship with our clients is dis-intermediated by umpteen different representatives. It is just not possible for us to access them.

Q203 Nadhim Zahawi: Why is that? There are technologies available now that mean you can talk to all the different stakeholders.

Neil Woodford: We often do not know who our clients are.

Q204 Nadhim Zahawi: Shouldn't you find out?

Neil Woodford: We cannot find out; we are not allowed to find out. We do not own the customer relationship, for example. It is owned by intermediaries.

Q205 Nadhim Zahawi: So you could consult with the intermediary.

Neil Woodford: Yes, we can, but again, coming back to the point that has been made here, many of those intermediaries are not interested in asking you about corporate engagement.

Q206 Nadhim Zahawi: It depends how you ask them, right? There are technologies available now for you to engage. This place engages with hundreds of thousands or millions of people. Other countries do the same thing in lots of different areas of business. It is available. I put it to you that there is a sort of reticence from your side of the fence to say, "Actually, that is the way we have always done it; we are going to carry on doing it that way because my reputation speaks for itself," which is fantastic, but you should not close your mind to what is available nowadays. There is technology that has moved on.

Neil Woodford: I am very aware of what technology exists.

Nadhim Zahawi: So why not use it?

Neil Woodford: I am not suggesting that my industry is doing a good job. By the way, I am not defending it.

Nadhim Zahawi: It sounds like it.

Neil Woodford: I am saying that I am an exception in the industry. I take corporate engagement very seriously and I spend a lot of time on it. I can submit umpteen amounts of evidence to demonstrate that.

What I am saying to you is that typically I am on my own when I am engaging or among a very small number of people who are engaging with companies. The industry, I believe, is failing on this point. I am trying to offer some explanation as to why. But it is possible, even when you do not have that direct relationship with your clients, to accept the responsibility of ownership, as I do.

Q207 Nadhim Zahawi: The issue I am taking up with you is you opened with a statement saying, "It is not possible for me to engage." I do not believe that is true in today's world. Thank you, Chairman.

Chair: I think Steve Waygood wanted to come in on this.

Steve Waygood: Thank you, Chairman. Many companies routinely now engage with stakeholders, and that kind of engagement is, of course, something that we support and encourage them to do. We, as Aviva, have 14 million retail customers in the UK. Whenever we have raised questions like this, many of them, once it is explained to them what it is we are doing, are genuinely interested in understanding more.

However, I mentioned at the very beginning of this meeting that the active informed demand for good stewardship is missing. To me, this is a function of poor financial literacy in the UK. There is an opportunity in the revision that is currently under way of the syllabus to integrate issues of stewardship within that. Of course, that is a long-term way of dealing with a short-term problem. It will take many years before those people are demanding good practice from us.

The central problem is demand—informed demand. They would also need quick and efficient ways of overseeing something that is very complicated, so any work that is being done to develop a standard is something that we would very strongly welcome.

Q208 Rebecca Harris: What opportunity is there now for clients to make their views known to you? What opportunity is there for clients to influence your voting decisions at the moment? This is particularly to Neil.

Neil Woodford: In my particular example, when I interact with clients, or when people who work with me interact with our clients, there is an opportunity then for them to express their wish and their desire for us to engage with the companies in which we are investing. I absolutely agree with the point that has been made on this panel, which is that there is very little attention paid to this. Sometimes we are offering up the whole subject of corporate engagement and activism with our clients, rather than the reverse.

Chris Hitchen: It depends on who you mean by client, though, doesn't it? If we are looking through to the end investor, then I accept it is not impossible but I would agree with Neil it is difficult. One of the Kay recommendations was that Government should facilitate individual electronic registration, which has really not happened in this country. That would make it much easier to democratise shareholders.

Where the client, as far as the fund manager is concerned, is a governing body such as a trustee, the mechanism is there for that relationship to happen—for the client to instruct the fund manager. We certainly do that. But I would say that fiduciary duty is a concept that occurs a few times in Kay's report, and it really goes to the core of my job. It is not the same thing as doing what your members want you to do; it is doing what is in their best interests, and those two things are not always the same.

Nadhim Zahawi: But you can explain that.

Chris Hitchen: Indeed.

Q209 Rebecca Harris: This is a question for Anta Skipper and Steve Waygood. Aviva was recently forced into this “shareholder spring” spotlight last year, when about six out of 10 votes failed to support the pay policies the company put forward. Firstly, what proportion of Aviva shares are held by institutional investors?

Steve Waygood: I should emphasise we work for Aviva Investors rather than Aviva, so we will need to come back to you to give you an absolute fact. I would estimate the majority, if that gives you a ballpark for your subsequent question.

Q210 Rebecca Harris: My next question is: what effect do you think this shareholder activism had on short-term performance or the long-term outlook? What would you say was the impact of that?

Anita Skipper: It was a case where activism from disgruntled shareholders had an effect, because there is now a new chairman, a new CEO and a review of the business. This is activism in practice.

Q211 Rebecca Harris: So it benefits long-term performance?

Anita Skipper: That is why shareholders would do it.

Rebecca Harris: So it has an impact?

Anita Skipper: Yes.

Chris Hitchen: The important thing is to create a climate where companies are well governed, and so our interventions are not so much a kneejerk to say, “We do not like you or this particular thing.” It is more to create a climate where people are encouraged to do the right thing. In our own case, we are routinely voting against around 40% of remuneration policies, but it was pretty much the same before the shareholder spring.

Anita Skipper: It was.

Steve Waygood: In terms of our own voting levels, they are similar. One of the things I would also highlight, given that you have raised incentives, is I very strongly welcome Kay’s own focus on incentives within the system. The debate around the Shareholder Spring has, particularly last year, focused, possibly unhelpfully, on just board pay.

We have heard about a tip of the iceberg already, but pay is the tip of a different iceberg. The supply chain of capital has many intermediaries within in it, so I think it is a very healthy conversation to be having around how one restructures broker incentives and how one restructures fund manager pay. How are the incentives around investment consultants restructured so that the short-termism that you are analysing is reconsidered throughout the entire incentives of the supply chain?

Chair: We will be coming on to these issues.

Steve Waygood: This morning? I do have a specific point I wanted to highlight, so do you mean we will be coming back to them this morning in this questioning?

Chair: Make it now, if you wish to.

Steve Waygood: Thank you very much, Chair; I appreciate that. We have been working with Tomorrow’s Company to produce something called Tomorrow’s Capital Markets.

Q212 Mr Binley: You are not selling to us, are you?

Steve Waygood: It is free. We have sponsored this study and made it freely available. We are inviting other fund managers, other consultants and other brokers to work with us and Tomorrow’s Company to open up how their incentives are structured and then try to establish how to include questions of stewardship and good ownership within that area.

If I can make a general point, our industry spends a huge amount of time and money trying to analyse how well fund managers enhance returns—how we are adding alpha to our clients. There is very little time or money spent on the question of how we are doing good stewardship. Yet I believe that is an industry that can be measured. There surely should be ways of measuring the substantive performance around engagement and voting and interactions and how we have held managers to account for their own governance of the firm. There are not those measures and metrics.

There are a few areas, perhaps, where they are evolving. One area is the UN-backed Principles For Responsible Investment, which now has over $30 trillion worth of backing. They have an annual assessment of their members' performance in this area, and there are elements of that assessment that could be harnessed to actually measure the performance in stewardship terms.

As a final point, Kay's review does not look at that. It does not look at how you measure stewardship. If we were to look at that, you would manage what you measure, and you would start to see a transformation there.

Q213 Paul Blomfield: Neil, you were talking a moment ago about the barriers, limitations and difficulties with engagement, but your website says that shareholder activism is fundamental to good corporate governance. How do you define shareholder activism and what do you think needs to change to improve it?

Neil Woodford: In brief, I would say that, if you think like an owner, you will be by definition actively involved in stewardship and governance of the company. If you believe that at the first disappointing piece of news or the first opportunity you can exit the shares and move on to something else, then you will never think like an owner, and therefore you will not be actively engaged with that business. Ownership is crucial—a sense of ownership on behalf of obviously the asset owners as well as the asset manager. You can behave like an owner by proxy.

Q214 Paul Blomfield: How do we get to the point where people are thinking like that? What needs to be done?

Neil Woodford: We talked about incentive structures, and what we need to do as an industry is to think more long term about our investments, and the failure in the industry that Kay points out so well is a product of excessive short-termism. The short-termism exists at almost every link in the chain that exists between saver and company. We need to tackle that short-termist culture in each segment of the chain.

Asset managers need to recognise their ownership responsibilities more readily. The intermediaries who represent the savers, the clients, need to think about the incentive structures that they put in place, which create the wrong sort of behaviour in the asset management community. Regulation has a part to play as well—excessive regulation—and remuneration, of course, in the fund management industry. In the links in the chain, there are also issues that need to be addressed.

There is no one silver bullet; I agree with Kay that there is no one answer to this. Where we are today is the product of 20 or 30 years of market history and regulation, and it will take a long time to get to a better place. To my mind, there is no single thing that can deliver that outcome, but lots of little things can encourage the right sort of behaviour over time.

Anita Skipper: FairPensions' clarification of fiduciary duties could actually help here, so long as the result of the Law Commission's work goes in the right direction and says it is a duty for owners to think long term, but if it does not, then we start all over again. Basically the whole chain has to have the same sort of basis of duty, right through from the ultimate owner to the company.

If you start with a pension fund who has a duty to be long term, that will then filter through to the fund manager, who will then engage on a long-term basis, and then it will affect the company and allow it to have long-term shareholders. Until that alignment is there, you will have all the short-term investors coming in and becoming too much of the critical mass. We are not saying that everybody needs to be long term, but what we are saying is that we have not got a sufficient critical mass of long-term investors.

Q215 Paul Blomfield: Can I come to one of Kay's specific recommendations? As Neil says, there is no one silver bullet, but one of the specific recommendations is the investors' forum, which has being welcomed. However, when we met Lord Myners, he was supportive but sceptical that it would have an impact. Chris, today you have defined its role quite narrowly.

Chris Hitchen: I tried to explain the thinking.

Paul Blomfield: I wondered what you all felt about the investors' forum in terms of addressing some of these issues.

Chris Hitchen: I have explained the thinking that the Advisory Board had around it. It is easy to be sceptical about it. As I have said, initiatives have foundered before. I do think Lord Myners is someone who could make it happen, as it happens, but that is a matter for him. We did see it very much as providing a safe environment for investors to come together to engage on particular companies and issues.

Q216 Paul Blomfield: Is that how everybody else sees its role? Do Neil, Steve and Anita see the role in that way?

Neil Woodford: As a practitioner, I would say investors are not good at coming together and talking about investment issues. Corralling investors is a bit like herding cats. It is very difficult to get investors even to agree to meet on a particular subject, even if it is particular egregious.

Chris Hitchen: They are scared to meet, because the FSA or Takeover Panel might be suspicious.

Neil Woodford: That is one of the principal reasons why investors are reluctant to communicate with each other. I have had umpteen examples of trying to pick up the phone to CIOs in rival fund management groups, who have expressed encouragement but little more than that and wished me luck in a particular endeavour. I believe a lot of other things need to happen alongside an investors' forum to get the best out of an investors' forum. On its own, I do not think it will achieve very much. If other things were put in place around it, I think an investors' forum could be really beneficial.

Q217 Paul Blomfield: Could I press Chris a little bit more on it? The way you describe it is almost as a tool for crisis intervention as opposed to something that could actually shift the culture and approach that Neil was talking about, and I just wondered how the rest of you felt about that.

Chris Hitchen: Sorry, are you pressing me or the others?

Paul Blomfield: I would welcome other people's views, but could you just come back?

Chris Hitchen: We are all in better shape as regards having generally improving standards—ratcheting up codes and those kinds of things. Business as usual day to day is less in need of a specific intervention. It is really how to deal with a particular takeover or whatever it might be, where we could probably get a better outcome if there was a safe place for people to talk about it.

Anita Skipper: Part of the reason why there is not much enthusiasm at the moment is that it has not been defined. People are not sure what this forum is supposed to be doing over and above what already happens. We think there is potential and the forum can add a lot of value.

Q218 Paul Blomfield: How do you want it defined to do that? Steve, you might be going to answer that.

Steve Waygood: Yes, absolutely. As has been alluded to by everybody, there have been a number of attempts to do this before. What is different this time? Why should the industry stand up and supply more stewardship simply because it has been suggested by a review? For me, one of the key questions is how much resource that forum, or those fora, will have. I do not think it necessarily needs to be just one forum.

I can certainly envisage a very positive role for the forum that is being discussed by the IMA. I would encourage the market perhaps to supply more, and for there to be a competitive environment. There is nothing de facto about a forum that means that collaboration will be more effective or efficient and lead to better portfolio decisions.

Fora can be extremely bureaucratic and ossify our ability to engage; they do not always necessarily work well. The ones that work well are the ones that are well resourced, and we have a proposal for that. It actually touches on the submission that Lord Myners made to you too, where he was talking about how research commission could be allocated.

Very simply, I have two budgets that I can call upon. One is the budget that pays for the people in my team, so that comes from our P&L as a firm—from Aviva Investors' own bottom line. There is also research commission, and that commission is generated every time we make a trade on our clients' portfolios. It is our clients' money that generates that commission, and roughly about 0.15% of every transaction is a commission. Two-thirds of that, if it is a large UK company, is funding research in the sell-side, so brokers.

I believe if we were to create an enabling environment across the City that encouraged—not required, but encouraged—fund managers to allocate a proportion, let's say 10% to 20%, of their research commission towards stewardship, meaning brokers analysing the quality of governance, the quality of the sustainability strategy of the company and its business ethics, then I think you would see tens of millions of pounds more funding good stewardship work. I would envisage at least one of the investor fora, if not many, being fundable through that way. Why shouldn't independent research cover stewardship? Why shouldn't it cover corporate governance?

At the moment, the point to emphasise is that many of my peers within other fund management institutions do not use their research commission pot of money to invest in this way. We do; Aviva Investors does. But I know a lot of our compliance colleagues in other firms are hesitant. You will have seen the press today looking at corporate access as an issue, so understandably you have very hesitant compliance teams.

A transformative proposal is embedded in one of Lord Myners's suggestions, which is to enhance the use of research commission for stewardship. That has not been considered in the Kay Review: how would you finance the forum? How would you fund stewardship? I find that an odd anomaly, given that clearly we are talking about an area of economics.

Q219 Chair: This is a very significant suggestion that you are making. Chris, if I can put you on the spot, why did Kay not make any observations on that?

Chris Hitchen: On the way it should be funded? Professor Kay devoted basically a year of his life to the construction of this report, and I think most commentators would agree it is an extremely elegant and accurate picture of the world we find. As Neil said earlier, the solutions are not easy to find, and I would agree that if the pendulum spent 30 years swinging this way, it is going to take 30 years to swing it back the other way.

Q220 Chair: It seems odd to the layperson that an exercise that took so long should not actually make that many positive recommendations at the end of it, particularly when we have just had one here today that would seem to be, if you like, waiting there to be introduced.

Chris Hitchen: I did not write the report. I can speak for the discussions we had around the Advisory Board. Ultimately, if we had had another six months or a year, we might have gone further into the solutions, but I think Professor Kay felt that other people would come forward to do that.

Chair: I will bring you back in, Steve, then I will come back to Paul, because I am conscious that we are running behind time.

Steve Waygood: Just very briefly, this is an idea that has come to us through reading the Kay Review and participating in the conversations afterwards. We did not submit it whilst Kay was considering his evidence, so it has been inspired by these conversations.

Chair: We will see Kay as an inspiration. I believe Paul has to leave soon.

Q221 Paul Blomfield: Let me just pursue this a little bit more, moving away from the investors' forum and looking at the other options that Neil was talking about. Kay talks about the two choices facing investors as voice or exit. In what other ways can we do more? In what ways can Kay's principles be implemented to encourage more investors to choose to change weaker companies rather than simply sell on?

Steve Waygood: The demand for stewardship: the suggestions that we have made around how consultants could be encouraged to measure stewardship, and how consultants could then be encouraged to advise their clients. It is not just pension schemes; I should also highlight that insurance companies of course own a considerable amount of the UK stock market. It is a matter of introducing standards and measures of good stewardship through the supply chain and the oversight chain and enhancing the financial literacy of the end investor, so that their IFAs, the Individual Financial Advisers, are also encouraged to scrutinise retail fund managers as well.

There needs to be a series of interventions in the whole chain—the demand and the measurement of stewardship. That goes for brokers too. One could require of a broker in their detailed notes on companies to offer a view on the corporate governance. It is exceptional when they do, these days; they do not.

Neil Woodford: Incentive structures are really important around performance measurement and the hiring and firing of fund managers like us. If those incentive structures were shifted to a longer term perspective, that would be a very important step in encouraging longer term behaviour and more engagement, i.e. voice over sale.

Chris Hitchen: That is true both of the fund managers and of the company managers. Arguably, long-term share ownership is the best way to align the interests of the company management with those of the investors. Similarly for the institutional investors, or the agents, I would like to know that your long-term remuneration is going to be broadly aligned with the needs of my members. So that is a key point.

It is about defining what success is as well. Success should not be about beating the market today and beating the market tomorrow. To an extent, that makes it incumbent on us as trustees and trustee representatives to really find different ways of measuring success. It would probably have to be more around, "Have you contributed real value to my pension schemes' assets over many years?" rather than, "Have you beaten the market last quarter?"

Chair: There is a danger that you start debating amongst yourselves, and I realise that when you have got like-minded people all interested in the same thing, that can happen.

Paul Blomfield: Neil was agreeing, were you not?

Neil Woodford: Yes, I was agreeing.

Chair: I am conscious of the fact that we are running way behind time, and we have got another panel, so can I bring in Caroline Dinenage now?

Q222 Caroline Dinenage: Steve, and Anita as well, you have mentioned stewardship quite a lot this morning, and it is something that we have heard a lot about. Do you think the code is fit for purpose and what changes would you make to it?

Steve Waygood: Yes, we do. I am disappointed with the number of pensions that have signed up to the Stewardship Code. One of the proposals that we made earlier was around how we could finance stewardship through research commission. Personally, if I was rewriting the Stewardship Code, I would add a provision in there encouraging those people who sign up to the Stewardship Code to examine how they use their research commission to promote and finance stewardship. I could carry on, but those would be the two biggest things for me.

Q223 Caroline Dinenage: What incentives are there for the industry to take these codes on voluntarily?

Steve Waygood: Comply or explain matters. We have seen it work well in the UK corporate governance listed environment for plcs. It only works really well if the people who are being explained to read it and then feed back to the people who wrote it what they think. That is the bit that is missing. In the UK corporate environment, there is an AGM and a series of votes at the AGM that enable the owner to then communicate formally back to the company. Of course there are in between times plenty of meetings too that enable that to happen. We have the meetings in the investment world—we meet our clients—but we do not have a formal opportunity for them to say what they think about our Stewardship Code. The oversight bit is missing with comply or explain.

Anita Skipper: It goes back again to the demand side of it, because if you are not complying with the code and you have not got your name on the FRC website and nobody cares anyway, then nobody is incentivised to do it. What you need is an environment where complying with the code is something that is seen as a good thing and that everybody is supposed to do, but we are not there yet.

Q224 Caroline Dinenage: How long do you think we should wait to see if firms volunteer to take on the code before we insist on legislating them to do so?

Anita Skipper: A lot of fund managers have already signed up. The disappointing bit is that the owners have not signed up. You want the owners to sign up so that the fund managers actually do the work for them. Fund managers do see the benefit of engagement, which is why Neil spends so much time engaging with companies, but it is very difficult to keep increasing that when nobody is asking you to do it and they do not even care. The focus must be on demand from our perspective.

Neil Woodford: On its own, I do not think it can achieve what it sets out to achieve. We talked today about lots of little steps to encourage different sorts of behaviours. On its own, the code is a splendid document. Our Stewardship Code is a splendid document. But even within my organisation, I doubt whether many of the fund managers who are engaging with companies have even read our Stewardship Code, let alone implemented what we say we do. So there is a certain amount of paying lip service to it. We have evidence there it is sort of a box-ticking mentality to a certain extent.

Again, coming back to what I said earlier, you have to think like an owner before you can take those Stewardship Code responsibilities seriously and implement them in how you run money for your clients.

Q225 Caroline Dinenage: Would you advocate some kind of compulsion, then?

Neil Woodford: I am instinctively concerned about too much regulation. Kay talked about this again in the review. Regulation is encouraging the wrong sort of behaviour, so more regulation may not be the best way to go, or if there is more of the right sort of regulation, there should be less of the wrong sort of regulation commensurate with that. I am nervous about too much regulation but, in and of itself alone, it will not deliver what we want it to deliver. Behaviour has to change over time with a whole structural change in terms of incentive structures in the industry.

Anita Skipper: What I think has made a big difference is just the publicity this has all got in the press every day. That has started the momentum towards much more awareness of stewardship and long-termism. It would be helpful to be able to keep that profile until we actually achieve whatever it is we are trying to achieve.

Q226 Caroline Dinenage: Can I move on to Chris, please? The pension industry will soon be seeing a massive expansion due to the auto-enrolment scheme. Do you feel that the industry is ready for this, and what changes are being made to prepare for the new clients and funds?

Chris Hitchen: I perhaps should declare I also happen to be a trustee of NEST, the new Government-sponsored pension scheme, which will be one of the vehicles used for auto-enrolment. We are seeing the potential emergence over the next decade of a relatively small number of large players in the defined contribution world. There is a reasonable chance, particularly with initiatives such as Pensions Quality Mark, which I already mentioned, that those will in the main be well governed, whether through trustee structures or other means. It could be a way of ensuring that UK institutions do have that scale, which in the main they so far lack. The long-term picture might—provided those institutions are allowed to get off the ground—be better in terms of ensuring that savers are appropriately represented.

Chair: Can you address your remarks to us rather than fellow panellists? Have you finished now, Caroline?

Q227 Caroline Dinenage: Just very briefly, do you think that governance and stewardship practices in the pension fund industry need to change to accompany the greater influence that pension funds will have in terms of their market share?

Chris Hitchen: As I said earlier, there is a dip at the moment; pension funds have been on the wane, and it is going to be a while before the new schemes really rise again. There are constantly advances in technology, and certainly at NEST we are thinking very hard about how we ensure that there is direct engagement and information available to scheme members, whilst still remembering, as I said earlier, that we have to do what is in their best interests, rather than what they might actually want us to do.

Q228 Katy Clark: Short-term shareholders can influence mergers and acquisitions, often forcing decisions on longer term shareholders that perhaps they do not want. Do you think that short-term shareholders should continue to have the same voting rights as those with perhaps a longer term interest in a company?

Anita Skipper: Yes. I think that the "one share, one vote" principle is the fairest principle. There are too many problems once you start giving out differential voting rights, and things that are not actually supportive of what we are trying to do here. You could entrench management whom you are trying to persuade to change what they are doing. Because of differential voting rights, they are entrenched. So there are lots of reasons. It is practically quite difficult as well, so we would prefer other means of actually making things more long term.

Q229 Mr Binley: Can I pursue that? Can I refer to Cadbury? That was a pretty glaring example of short-termism in takeover situations. I wonder whether we ought to be crude enough to say, "You have to own shares for three months before you can vote on the future of the company"? Is the only way to deal with it a very crude line?

Chair: The takeover code has basically kicked this into the long grass.

Mr Binley: Yes, and I would like you to think again about it.

Neil Woodford: The subtext here is that the market in corporate control should be controlled. I am instinctively reluctant to agree to that.

Q230 Mr Binley: We are just talking about those people who can vote in a takeover.

Neil Woodford: Cadbury was sold in the end because the long-term shareholders accepted.

Q231 Mr Binley: Cadbury was sold in the end because they were bullied to sell in the end; let us be perfectly true with it.

Neil Woodford: Cadbury's shareholders decided that the price that was being offered was attractive enough for them to want to sell their shares to the bidder. It is a simple law of economics that dictated the outcome of that particular bid, as in most cases.

Q232 Mr Binley: You are perfectly happy with an American hedge firm being more involved in British industry than they perhaps should be.

Neil Woodford: That is not what I said. What I said was that the long-term shareholders who owned Cadbury decided that the price that was being offered was attractive enough for them to sell their shares, because there is always, of course, an opportunity cost associated with investment. You can take your capital from your particular investment and deploy it more productively elsewhere.

Q233 Mr Binley: I think that is a very kindly view of what happened there. Are you telling me that you do not think that there ought to be a time limit before you are able to vote on the future of the company? Shouldn't you have some involvement for some time before that happens?

Neil Woodford: I am not saying that necessarily. All I am saying is that it was the long-term shareholders of Cadbury who dictated the outcome of that company's fortunes. It was not the hedge funds. They sold in the market to them—to the arbitrageurs.

Q234 Mr Binley: They had no alternative, but never mind.

Neil Woodford: They had alternatives.

Q235 Chair: We could probably hold a separate enquiry into this, and in fact we already have done. The basic point, leaving aside the Cadbury issue, is whether there is an argument for restricting the ability of short-term investors to intervene in a takeover situation.

Chris Hitchen: Just very briefly, I think there is a case for looking at whether you should be able to borrow shares to vote, and that is something the Government may wish to think about, and there are different ways you could address that.

Chair: Can we move on? I have got Julie Elliott now. Some of these issues have been covered, so please pick out those that have not.

Q236 Julie Elliott: As a matter of procedure, what steps do you take to check the suitability of companies that you invest in? Specifically, what do you look for when checking the companies?

Neil Woodford: How long have you got?

Chair: Not very long.

Neil Woodford: When you are analysing companies ahead of making an investment decision, the process never ends. You never stop analysing them when you have invested. If anything, the intensity of your scrutiny increases. You look at a whole host of things. Ultimately, an investment decision is really about value discovery. Kay talks about this in the review.

My job is really as a value hunter. I am looking for undervalued situations in the market. The most attractive or the most undervalued situations are, by definition, the best investments. The whole process of investment analysis is really about identifying undervaluation—the mis-pricing or the mis-valuation of assets.

Q237 Julie Elliott: Do you think you are quite successful at doing that? Do you think companies are good at doing that?

Neil Woodford: Companies?

Julie Elliott: Well, organisations.

Neil Woodford: I think the track record of fund managers speaks for itself, broadly, in that when you measure the average fund manager, he does not beat the index. In many respects the industry falls down, but of course by definition the average fund manager will not be able to beat the index; we are, after all, contributing to the index. There are examples of fund managers consistently beating average returns. You have got to measure those returns over a very long period of time. As I said right at the start of this process, I have been managing the same fund for 25 years, and if you want to look at the long-term track record of that, I encourage you to do so.

The fact is, it is possible to deliver superior long-term returns, but you have got to have the right approach and focus on value discovery rather than—as we have talked about all day—the obsession with price over value, for example, which is inappropriate. It is possible to beat the market; it is possible to justify your existence and undertake your socially useful functions as well in improving the performance of companies and benefitting the economy in the process. The industry unfortunately is not set up sufficiently well to deliver that outcome. That is why we are here today.

Q238 Julie Elliott: Would everybody agree with that?

Anita Skipper: Following on from what Neil said, once you have made that decision and you have bought into this company and it is a strategy that you like, the ongoing engagement is whether they are sticking to the strategy, whether the people who are actually running the company are competent to run it and whether they are going to stray from the strategy.

Quite often we get involved with the fund managers because the company is doing something that we had not bought into and it is a surprise. That is why, once you have made a decision, as Neil says, it is an ongoing thing, and in fact your scrutiny gets even greater as time goes on, because it is even more important then. You have spent all this money, you have held it for many years in this company, and you want the returns at the end of the day.

Steve Waygood: The only thing I would add to what has been said before is that, going back to the first question at the beginning of this meeting, one of the transformations that we have seen in this industry over the last 10 years is that very large organisations like Bloomberg, MSCI and Thomson Reuters are now adding to the conventional financial metrics qualitative views on the governance of the firms and their sustainability: how they deal with their customers and how they deal with their employees. It is beginning to be possible to enhance the qualitative view of the company with these metrics from, for example, Bloomberg.

In the last three years, we have been very actively adding various measures of the integrity of a firm to our security selection process, portfolio construction and portfolio risk management. I am not pretending for a second that we have finished or we have got it 100% perfect, but what it adds to the view is interesting. It really does deepen it. It is an odd observation that Aviva Investors is one of the very few firms to have done that systematically. What is good is that the likes of Bloomberg now cover this.

Q239 Julie Elliott: Would you say that this extra information has made a difference in terms of the companies you invest in?

Steve Waygood: Yes, it does. Often it reinforces what was the fund manager's view already, and you would expect them to align, if you like. But where there is an anomaly—a company that has good financial prospects comes through MSCI's intangible value analysis tool with a ranking of triple C, which is very bad—that gives us an opportunity to then have a conversation with the fund manager about why it is ranked like that. It could be that we might sell down the holding, so the exit, or we could engage: the voice that Albert Hirschman talks about and that Kay uses as a key reference. There is a lot more to do. If you wanted to come and pay us a visit, we would be very happy to take you through the process.

Chris Hitchen: It is fair to say that we are talking about one particular kind of fund management, and there are many other kinds of fund management.

Chair: We need to move on.

Chris Hitchen: There are many reputable companies that use quantitative techniques, but many shares are actually traded by computers doing high-frequency trading.

Chair: We have covered that with other panels, and to a certain extent we will go on to that.

Q240 Nadhim Zahawi: A quick question to Chris. You are a member of the Kay Advisory Board. What advice did you give Professor Kay about the balance between voluntary best practice and formal legislation?

Chris Hitchen: All of us agreed that, if you can get the market to produce good solutions, that is usually preferable to regulation. However, we did feel there were areas where the market has had 30 years of going in the wrong direction, as we have said, so some Government nudging to push it back in the other direction is probably necessary at that point. There are 17 recommendations in the Kay report. A few of them ask Government to do things, but there are actually more that ask other people to do things. Government should do the things that we asked them to.

Q241 Nadhim Zahawi: What recommendations fell away from the 17 that you may have discussed that you would want the Government to do?

Chris Hitchen: Where did we fear to tread?

Nadhim Zahawi: Slightly.

Chris Hitchen: As I have already said, we only had limited time. Professor Kay in particular spent a year of his life on this but did not have any more time to spend on it. One area that perhaps does not come out as much in the report, although it is there, is around the potentially perverse effects of high-frequency trading and what happens on the sell-side. Around the table we were reasonably well disposed towards a financial transaction tax, which might help to mitigate that. We did not pursue that, but it is something we definitely picked up.

Q242 Nadhim Zahawi: Why didn't you?

Chris Hitchen: We had limited time and we were also aware that it might be an area that would need quite a lot of work with Government to get all sides of Government lined up behind it. I am not an expert on this matter.

Q243 Nadhim Zahawi: That is not a good reason for not pursuing it—that it required more work. You could have suggested that that is what needs to happen.

Chris Hitchen: Sorry. Professor Kay has already been before you, I think, and has probably already touched on this issue. We were minded to think it was a good idea. There are problems with imposing any sort of tax on a partial basis in a global market, so that was one reservation we had. Frankly, we were also aware that there was a potential short-term detriment to UK plc in doing things to hurt the City, and we had to be cognisant of that.

Neil Woodford: We already have a financial transaction tax.

Chris Hitchen: We do on end investors, but not on professional investors. It is slightly the wrong way round.

Neil Woodford: Yes, it is the wrong way round.

Q244 Nadhim Zahawi: So you are in favour of a financial transaction tax if it is implemented globally. Is that what you are saying?

Chris Hitchen: It could potentially take a lot of unnecessary trading out of the system. Who pays for the profits of traders? Ultimately it seems to me it is the end investors; it is my members. Even if we end up paying a small tax on the trades that we do, if it stops us paying a lot of profits on other peoples' activities, then we are still better off, net-net. That is my view.

Q245 Nadhim Zahawi: Do the rest of the panel share that view?

Steve Waygood: I would be very happy to say "yes". We only agree that the financial transaction tax is a good idea if it could be done simultaneously in all key financial jurisdictions. Unfortunately the political practicalities of that mean that it might be an academically good idea for Tobin 30 years ago, but the current manifestation of it is not something that we would support.

I hope what I have been very clear about is our recommendation, which is similar in a sense, that we should use the existing commission. So not just have the commission there to sit as a brake on the system, but also hypothecate the commission itself, so that you are funding better stewardship. In fact, for me, there is nothing de facto that hypothecation will happen with the revenues of the FTT, and in fact the treasuries around the world have a very poor record on hypothecation. So that is one of the other reasons why we are not in favour of the FTT.

Chair: I am getting a lack of enthusiasm on the FTT.

Neil Woodford: It is going to be really hard to get the universal outcome that we want, so disproportionate FTTs would be damaging, potentially.

Q246 Nadhim Zahawi: Just very briefly, Chris, you mentioned the recommendations from Kay. Which ones do you think most naturally lend themselves to formal regulation?

Chris Hitchen: At the risk of repeating ourselves, we did feel that the investors' forum required some sort of Government backing, if only to get over the perception that regulatory authorities would be against this sort of thing. One thing that was touched on this morning as well was the question of fiduciary duty, and the extent to which that can be forced through the investment chain. At the moment it applies at my end of the chain but it does not apply at the transactional end, and Government intervention may be required to prevent it being stopped from going down the chain by contractual arrangements. Those are the two I would cite.

Chair: That concludes our questioning. It is has taken rather longer than I expected. Thank you for your contribution. That is incredibly helpful, and I will finish as I finish with other panels by saying that, on reading the transcript of this, we may feel there are further questions that we would like to ask. We would be grateful if you could respond to them. Similarly, you may feel that there are questions that we should have asked but did not or that you would like to supplement the evidence you gave—feel free to write in to us. It will be incorporated in our final report. Thanks very much. Can we have the next panel, please?

Examination of Witnesses

Witnesses: **Daniel Godfrey**, Chief Executive, Investment Management Association, **Guy Sears**, Director, Institutional, Investment Management Association, **Penny Shepherd**, Chief Executive, UK Sustainable Investment and Finance Association, and **Matthew Fell**, Director of Competitive Markets, Confederation of British Industry, gave evidence.

Q247 Chair: Good morning, and thank you for waiting patiently. I apologise for the delay. One of the reasons for that is we had rather more questions for the previous panel than we have for you. However, that does not mean the responses you give may not generate further questions. Could I just start, as I did with the other panel, by asking you to introduce yourselves, and the organisations that you represent, for voice transcription purposes?

Guy Sears: I am Guy Sears. I am Director, Institutional, of the Investment Management Association.

Daniel Godfrey: Good morning. I am Daniel Godfrey, Chief Executive of the Investment Management Association

Penny Shepherd: I am Penny Shepherd. I am Chief Executive of the UK Sustainable Investment and Finance Association.

Matthew Fell: Good morning. I am Matthew Fell, Director of Competitive Markets at the CBI.

Q248 Chair: Thanks very much. I will just remind you, in case you were not here, of what I said to the previous panel. Some of the questions will be person specific, others will be general. Please do not feel that you all have to respond to every question if you feel that there is nothing really that you could add to what has been said by the previous speaker.

Can I start with a question to you, Penny? I will try to abide by my own strictures this time and be disciplined. In your written evidence, you state that UKSIF's aim is to "seek to ensure that individual and institutional investors can reflect their values in their investments". If Kay is successful, can you take your P45?

Penny Shepherd: Well, I am planning to take a P45 anyway. UKSIF supports financial services that advance sustainable development. We see an effective market in good ownership practice by investment managers as an important way of ensuring that investment services can effectively advance the public good as well as meet the needs of their clients. That is in part about enabling people to invest in line with their values, but it is not only that.

It is fair to say that, increasingly, investors are looking at environmental and social and governance issues, because they give additional insights into financial returns and because they are increasingly material to the success of a company in long-term value creation. Ultimately, we are interested in stewardship because we see a greater emphasis on stewardship as a necessary technique for ensuring that capital markets serve the public good.

Q249 Chair: From your different perspectives of the equity market, what do you see as its primary function and its different players? Who would like to lead on that? Daniel, you look as if you have got a response.

Daniel Godfrey: The primary function of the equity market is to get capital from people who have it to people who need it in an efficient way. As to the role of the different players, the role of the corporate who is seeking capital is to promote the success of their companies, and we would see that in a more holistic sense than perhaps has been the case in the past.

By that I mean that the success of the company is to have a sustainable, long-term supportable company that delivers not only returns to its owners but also opportunities for development and growth to its employees, plays a responsible role in the communities in which they operate and takes a responsible attitude towards the environment, and so on. In terms of the other players, the players go all the way down the chain to the individual investors and pension fund members who are providing, effectively, the capital that goes up through asset managers and through the buy-side in the market towards the companies.

Penny Shepherd: One thing I would add to that is one of the most significant things about the Kay Review is that it challenges that question of the primary purpose of capital markets, and it highlights that the purpose of capital markets is to meet the needs of the end users of the system, i.e. the company's need for capital on the one hand and the saver's need for appropriate returns for providing that capital on the other.

Over the last few years, the purpose of regulation of capital markets has been to ensure that the capital market works smoothly for the participants in the market. So it is a really significant shift from, "Does the engine work smoothly?" to "Does it actually get you from A to B?" That is a really important difference.

Q250 Chair: A previous witness—I think it was Lord Myners, and I am paraphrasing him—said, in effect, "Is the City here to serve the economy or is the economy here to serve the City?" What is your view on that? Penny, from what you said, I gather you think that regulation has reinforced a self-serving element of the City. I may have misinterpreted that, but I think Daniel wanted to respond first, and then Penny wanted to come in.

Daniel Godfrey: If you take the purpose of investment management, the relationship there is that clients, whether they are intermediated or direct, effectively give asset managers their money and trust them to use their skill, knowledge and experience to invest it in a way that will deliver them returns in a risk-appropriate fashion. Asset managers do not take money on to their own balance sheets, and that gives them a fiduciary purpose that they need to always be aware of.

I would say very much that the purpose of asset management is to look after the interests of clients, to allocate capital efficiently throughout the market and to do the best possible job they can. You asked whether the economy is there to serve the City, and I think there is no doubt that there has been a lack of balance in the relationship between society and the City in recent years. That is something that the industry, the Government, the regulators and society need to sort out, and this is part of that process.

Guy Sears: On the equity markets and Kay saying, "Do they actually serve the purpose?" there is a distinction in language. The equity market as an economic whole is there about the allocation of capital. The precise mechanisms used on the trading venues at the moment and in the structure of the stock markets—I think this is one of the things Kay talks about—are as much intermediaries with their own incentives as any other part of this chain. Sometimes they are not seen in that way, but they are. They have incentives that maybe drive tariff into types of trading that are not really serving this longer term interest.

Matthew Fell: I would just endorse what was said on the role. The provision and efficient allocation of capital has to be at the core of the function, and on the second issue the answer surely has to be that the City is there to serve the economy.

Q251 Nadhim Zahawi: We have heard that it is common practice for fund managers to vote on company matters without consulting their shareholders at all. Does this practice need to change?

Daniel Godfrey: There are a wide variety of different clients. You are talking about whether they consult their clients and end users about how they vote. Clearly, it is the right of a client to tell their supplier how they wish that relationship to be governed. If a major pension scheme says to a fund manager, "We want to dictate how you vote on any issue," then the supplier should say, "Absolutely, yes. But, of course, we want that to be taken into account when you measure how well we have done, because if you have voted yes on something that we would have voted no on, and then the whole thing has gone pear-shaped, do not come along and kick us for the underperformance of that holding." That is just the nature of commercial relationships.

You got into a bit of a debate with Neil Woodford about consulting the hundreds of thousands of individual investors. There is a demarcation between communication and control. It would be utterly impractical and probably not a great thing to set up some sort of internet voting mechanism, where every one of Neil's hundreds of thousands of clients could push "yes" or "no", and Neil would then vote accordingly. I do think that communication with your customers about what your process is and what you have actually done in principle is absolutely the right thing to do, and we should seek to move that forward.

I was interested in that part of the debate, because it must be 25 years ago that I set up one of the first ethical investment unit trusts in this country. Around that trust we put together an independent panel to look at the investments that the managers were making to see that they met the criteria, and we did have an annual general meeting whereby investors could come along and complain: "You have bought this company and they sell tobacco somewhere," or whatever it was. I felt that engagement was very helpful.

I think engage, yes, make decisions, no. In principle, when you hire an asset manager you are delegating to them the responsibility to buy and sell investments. Part of that probably should be by and large the engagement and the buy/sell decisions. Otherwise, how do you measure their performance? We need to have a much better understanding; we need to have much better practice; we need to have much more frequent practice; but ultimately you as a client should be choosing an investment manager because you like the way they do it, rather than trying to stand on their shoulder and dictate voting for them

Penny Shepherd: Building on that, in many ways I would endorse what Steve Waygood was saying earlier—that the key issue is around demand and around valuing good active ownership by investment managers. In many ways your question might be reinterpreted as the value of representative democracy versus the value of direct democracy.

At one level, to throw the question back, I would ask how helpful is it when your constituents tell you exactly how they would like you to vote on a particular vote in the House. The answer is that you are probably glad that they are showing an interest in the particular issue—you are glad that it is showing demand for your services as a representative—but at the same time you probably recognise that you have a depth of knowledge of that particular issue that not all the individuals who are telling you how to vote will have developed.

What we are concerned about is increasing that demand. One way UKSIF is seeking to ensure that is by co-ordinating the UK's first Ownership Day next week to raise awareness of the issue, because we are really conscious that, if you read the personal finance pages, it is all about how to pick a good stock picker. It is never about how to pick someone who is good at stewardship. I mean even if you look at the press coverage around Neil Woodford, it is very rarely about Neil Woodford as an active owner; it is much more about Neil Woodford as a stock picker. That is typical of the environment at the moment.

However, what we are saying in Ownership Day is, "Ask your fund manager what they are doing, because in many ways they are the experts." What our fund management members say to us is, "If an individual emails us and says, 'I would like you to vote a particular way with my shareholding,' actually that is welcomed." It is a demonstration of interest and not a lot of emails like that get sent—considerably fewer, I think, than the emails you receive about individual votes in the House.

Daniel Godfrey: You have reached the real nub of it in many ways when you talk about demand, because demand ultimately will be driven by belief, and the belief needs to be as to whether it adds value. Are we going to get better long-term outcomes by having good stewardship and engagement, or are we not? I guess your belief is that we will; I believe that we will. The evidence shows that we will.

But until the clients believe it, and believe it is worth paying to get it, what you are going to get is some people who really believe it, as you saw with Aviva, and who do it that way because they believe in it, and other people who do not really believe it going through the motions. That is why you get the box ticking and the boiler plating and the establishment of a patina of activity to defer attention from the press or the regulator or Government or politicians. That is why there is a very big education process required to bring people into the tent to put the spotlight upon them, and to convince people that this really adds value for the longer term. Otherwise, it is not going to really work.

Q252 Nadhim Zahawi: The reason why this is an important issue, and I will come back to Penny's point about reversing the question to us, is that some will do it really well. It is a bit like this place, where some politicians have embraced the new technologies and communicate with their constituents regularly and consult them regularly on how they should behave in this place. That is a good thing, and the same thing will probably happen in your industry, in the sense that those who will do it really well will flourish and do well in the new world. Those who do it badly will be found out, and those that do it as a box-ticking exercise will also be in a less comfortable position.

In terms of reversing, I slightly disagree with you. Yes, of course, demand is a challenge, but it is how you communicate in the first place—how you consult. I do not think it is a black and white issue of either saying, "Well, we are going to let them vote the shares and I am going to behave the way they want me to," or, "I just send them communications," as a one-way broadcasting exercise.

There are many more innovative ways today, whether in politics or in your industry, of consulting properly, i.e. setting the rules out to people saying, "Here are the trade-offs; here are the things I am thinking about"—because they are ultimately the experts—"What do you think?" Then the data comes back to you, and then you can act on that data. I do not believe you should not act on the data at all, and you should just say, "Well, they have bought into me because I am the expert and that is it." There are many better ways of doing it than this—forgive me for saying this—sort of old-school thinking.

Chair: I think we have got the message. Could you respond?

Daniel Godfrey: I think we agree that communication should be two-way, and it informs your decision-making just as your constituents may inform yours, but ultimately they have elected you to come to the House to cast your vote according to what you believe. It is a very good analogy to the fund manager, and the two-way communication needs to exist.

Penny Shepherd: Can I just add one brief point to that? One area in which this House can act to raise awareness is by acting as an exemplar of good practice. In particular, I do hope that you will encourage the Parliamentary Contributory Pension Fund to be an exemplar of good practice in this area. I certainly think from my understanding that there are opportunities for improvement there.

Nadhim Zahawi: That is a very good point.

Chair: That is very well put, if I may say so.

Q253 Nadhim Zahawi: My final supplementary: obviously, part of the problem is that fund managers have so many companies on their books, so practically how can we combat this over-diversification do you think?

Daniel Godfrey: The investors' forum could potentially be a way of helping with that. I recognise that it is very hard to get a consensus amongst investors, as Neil Woodford told you earlier. There are examples, for instance in Holland, of where organisations come together effectively to syndicate from the buy-side their research on stewardship and engagement and governance, so that you can spread the load across a broad number of investors. That could potentially be a role for the forum that Chris and Professor Kay had not envisaged.

In our discussions with investors, although it is not a universal theme, that has been raised by a number of them. People are saying, "Look, we cannot bring our A-game to every company that we own, because we just own too many of them. Is there some way in which the forum could enable us to come together to spread the load, so that the people who have either the highest motivation around a particular company or the greatest skin in the game could effectively be deputed under a philosophical framework about what good engagement and stewardship looks like, so that we can trust them to go and ask the right questions?"

Guy Sears: A key point, so it is explicit in what Daniel is saying, is this is about mechanisms for addressing the consequences of diversification, rather than suggesting people should not be diversified. It is very important we do not forget that the economic advantage of being diversified in a fund and suchlike is a very considerable one. There is just a cost that comes with it, and we are trying to address that cost, rather than suggesting you should not be diversified.

Q254 Mr Binley: A simple question to Mr Godfrey, primarily. You have launched a discussion about setting up the investors' forum. Can you tell us what progress you have made?

Daniel Godfrey: Yes, certainly. I would say there have been varying shades of enthusiasm as we have discussed it around the industry. We have tried to talk as broadly as possible, because we recognised one of the very valid points Professor Kay was making was around the fact that a decreasing proportion of the UK market is owned by traditional UK institutional investors. Foreign investors and sovereign wealth funds own an increasing proportion. We have talked to insurance companies, pension funds, investment managers, sovereign wealth funds and foreign investors. As I said, there is probably a spectrum of enthusiasm that ranges from highly enthusiastic to pretty much opposed to doing anything.

There are grounds to say there is already a lot going on; there are a number of informal forums that do work in some circumstances at getting people together and making things happen. The view that we expressed in November was that we felt that a formal mechanism with a thin layer of resource to actually drive the thing forward and do some of the heavy lifting would help. I would say that the majority opinion, in my view, would be fairly lukewarm support for the idea that, if we do not give this a really good go, we will never know whether we can make it work or not. We will seek to proceed from there if we can over the next few weeks.

Q255 Mr Binley: I am delighted by your display of enthusiasm; it is very commendable. You talked about foreign investors and sovereign wealth funds. How many foreign investors and wealth fund people have signed up?

Daniel Godfrey: We are not asking people to sign anything at this stage.

Q256 Mr Binley: So you are still in the preliminary stages then?

Daniel Godfrey: Yes, we are still in the preliminary stage of seeing if we can establish a sufficient consensus to bring forward some concrete proposals to make it happen.

Q257 Mr Binley: What is your target date for the first meeting?

Daniel Godfrey: The target date for deciding whether we have a sufficient consensus to move forward to the next stage will be over the next few weeks. What I wish to do then, if we are able to move it forward, is put this in the hands of actual investors—to take it away from the bureaucrats within the trade associations—to take forward the ideas and the information we have gleaned over the last few months and to ask them to take this forward to the next stage. But we would provide the secretarial and, if necessary, financial support to make it happen.

Q258 Mr Binley: What would be your target for setting this thing up, rather than talking about it? I admire your enthusiasm, but I want to know when it is going to happen.

Daniel Godfrey: If we are able to move this forward, I would think in the next four or five months that you would want it to be up and running.

Q259 Mr Binley: We shall track that, and that is encouraging. Can I just ask one final question? Lord Myners was pretty scathing, and the fact that you mentioned you want to hand it over to the trade, as it were, as opposed to trade organisations, suggests that you read those remarks. But if you did not, let me read out his fear: “What we will end up with is a forum that is dominated by trade associations, and trade associations’ modus operandi—their purpose for existing—is to protect the status quo.”

Daniel Godfrey: I could not disagree with Lord Myners more. I agree with him, though, very much.

Q260 Mr Binley: I will write to him and tell him that.

Daniel Godfrey: You do not need to; I have told him myself.

Q261 Mr Binley: You have done it yourself?

Daniel Godfrey: I have told him myself. Our vision of what is needed is actually quite similar, and Lord Myners has a very good way of expressing himself.

Q262 Mr Binley: You thought he was being naughty, did you?

Daniel Godfrey: I would not say that. I have seen worse.

Q263 Chair: There were elements in your response to Brian Binley's question that smacked of Sir Humphrey. Having a consultation to achieve a consensus and then moving it on. I mean are you actually driving this process with any sense of conviction? Was it delegated to you to take on—not you personally, but your organisation?

Daniel Godfrey: I had only been in position for a very short amount of time, so this is something very much I wanted to grasp, because it is something that I strongly believe in. There is definitely a sense of conviction behind this.

The subject of stewardship and governance needs to be elevated above the primary focus on issues around the board and issues around remuneration, which I acknowledge are very important. We need to look at stewardship as being around a real understanding and support by investors of companies' long-term strategies for sustainable shareholder return. It needs to be about understanding and support of the companies' management as being people who are capable of executing the strategy. It needs to be around an understanding of the companies' financing models, so that they have the resources necessary to execute on the strategy.

That is all very clear, but to get to your question, it is not easy, because there are a lot of different views. As Neil Woodford said, if you have 10 investors in the room, you will probably have 12 different views. I have to be quite careful in terms of how we move this forward to try to get sufficient people coming with us, because if you do announce something and no one wants to join in, it will be a missed opportunity. When you say you will track us over the next few months, you probably will not have to wait that long, because I think in terms of the work we are doing, it will either move it forward or kill it quite quickly.

Q264 Mr Binley: I was rather more gentle about my approach to you on bureaucracy than perhaps the Chairman was. That is why I asked you some closed questions, which I think you answered with alacrity. You did say that things should be set up in five months. Will you keep us informed?

Daniel Godfrey: Absolutely, yes. I think we will be back to you pretty well before then, because we will either be moving forwards with real intent or we will be saying our efforts have failed.

Mr Binley: We look forward to your regular updates.

Q265 Chair: One thing you did not answer was my question on whether the Government asked you to take this forward.

Daniel Godfrey: No. Well, the Government has encouraged us and others to try to produce a substantive and principled response to Professor Kay's recommendations. I do not think ours is necessarily the only game in town, but they are certainly supportive of what we are trying to do.

Q266 Julie Elliott: Matthew, from a British industry perspective, how will the investors' forum improve relationships between the players that are in the market? Do you think it will?

Matthew Fell: The notion of better engagement, better depth of understanding and better research on companies should over time lead to increased scrutiny and performance. Therefore, if you are able to both increase the breadth and depth of that research and understanding around companies, which the investors' forum seeks to do, that is a good thing. There are two challenges in it that will need to be overcome. The first is particularly on the investor side, if you like. How are you going to have a forum that is broadly sort of working in the same direction and striving for consensus on the one hand while all investors are trying to do the sort of value picking that we have heard about previously? How do you retain that degree of competitive edge within an environment of collaboration and consensus? That is a challenge to meet on the owner-investor side.

From the companies' perspective as well, the companies that are really up for good and proper engagement with shareholders will tell you they would like some of the different lines of questioning and some of the challenge that comes from different areas of their shareholder base. They would feel it a retrograde step if that was diluted and it was all condensed into just one view and one approach from the forum. Maintaining a sort of diversity of challenge on both sides is really important, but the overall notion of the forum is a good thing if it can add to a depth of understanding in research.

Q267 Julie Elliott: Thank you. To everyone here, who do you think are the essential people that need to be involved in this to make it work? Are they engaging with you?

Daniel Godfrey: The essential people are the investors themselves. To me, that would be the people making the buy/sell decisions within companies, but different investment managers are structured in different ways. So in some companies it will be the governance and engagement specialists as opposed to the actual heads of equities or chief investment officers or portfolio managers. Are they engaged? Yes, absolutely; they are engaged but, as I said, there is a broad range of opinion.

Penny Shepherd: The thing I would add is we see three particular groups within the investment industry practicing engagement. It is important that there is access to the investors' forum for all of them. Those three groups are, first of all, active managers of equities. As you say, they may be structured in different ways, but essentially they are people who make buy and sell decisions.

The second group are engagement specialists who are engaging on behalf of passively tracked funds, so on behalf of index-tracked funds. That is an important group as well. The third group are where asset owners have commissioned independent service providers to engage with companies on their behalf. So people like Hermes, for example; NEST uses The Co-operative Asset Management for that service; and so on. Similarly, it is also important that that group is involved.

Daniel Godfrey: I would agree with that, and if the forum is going to work, it needs to be as open to as many people as possible, because the broader it is, the stronger its voice.

Q268 Mr Binley: Kay recommended that companies should consult their major long-term investors over major board appointments. How I wish we had that ability in the House of Commons when it comes to the Cabinet, but sadly we do not. Why should companies consult with fund managers if fund managers do not consult with their clients?

Daniel Godfrey: There is an issue of delegation: firstly, fund managers will consult with their clients if their clients want it; secondly, fund managers, I think we have agreed already, could do more to engage in two-way conversation with their clients, whether they are large pension funds or small individual investors. But they have essentially been delegated to make these decisions.

Board decisions can be quite significant. I would not disagree that companies should consult with long-term investors over board appointments, but I think it is "consult"; I think that ultimately boards make decisions and shareholders have the opportunity to express their concern or disagreement with boards. Ultimately, in the UK shareholders have a huge suite of tools at their disposal to make boards do what they want, or ultimately replace them if necessary.

Q269 Mr Binley: I dare not mention the name Fred the Shred, do I? We might have had more input there, but that is another matter.

Daniel Godfrey: I think we have all learnt some lessons.

Mr Binley: I will not ask you to answer that one.

Matthew Fell: I was going to put an answer to your question in the context of clarity of the roles of the individual players in this. Absolutely, the shareholder's job is to decide whether they buy into the company's strategy and then to hold boards to account in discharging that. The board is there to set that strategy, and then to oversee it and delegate to the management the day-to-day running of the company. Shareholders will want to know and rigorously test the capability of boards to carry out and discharge that strategy, and that is why I think it is a good idea that there is that sort of engagement on key appointments.

Q270 Mr Binley: Let me just pursue Fred the Shred and the need for a sensible approach to the purchase of the Dutch bank. Would you have wanted more involvement in that respect? It has done the financial services sector immense harm.

Matthew Fell: From what I have heard on the investor side, there were attempts at engagement, and the view would probably be that there was not sufficient information and powers to genuinely hold the board to account in that scenario.

Mr Binley: That is fair.

Daniel Godfrey: I think investors would acknowledge that it was not their greatest moment. Having tried to convince the company that this was not a great deal, so many of them then voted in favour of the deal, and I think they would look back on this as something they need to learn from.

We can understand perhaps what was going through their heads at the time: "If we vote against this, it is going to destabilise the company and may impact on the short-term performance of the shares." The lesson learned there is that we need greater ability to follow through, so there was a problem, I think, in that you would express your concerns to the company, and if effectively they put their hands over their ears, the shareholders sometimes had a tendency to say, "Well, we have done what we could, and now we get on with it."

Q271 Mr Binley: With respect, isn't it a question of greater scrutiny and wasn't that lacking? I mean there is the very fact that he did not do due diligence to start with. Any company buying a company worth £100,000 would do a degree of due diligence. Isn't this a question of scrutiny and isn't that a factor that your forum needs to take into account?

Daniel Godfrey: This is an area where a forum could play a very significant role in ensuring that there is follow through, rather than momentum dissipating in the teeth of opposition. Yes, I would agree.

Guy Sears: I do not want to take anything away from what Daniel says. Clearly, there were responsibilities on our side, but also in this particular case, as with others where great damage can be done, these are regulated entities. There is also a different approach now by our financial services regulator that also is beneficial in terms of judgment on judgment. That is not to take anything away; I am just talking about the context of dealing with regulated entities.

Q272 Mr Binley: The words "light touch" come to mind.

Guy Sears: I do not think we are living in that environment now.

Q273 Mr Binley: Can I move on? That was a bit naughty. Professor Kay made a clear recommendation that quarterly reporting obligations should be removed from companies, something that I agree with. It is part of the over-regulation of processes. But I am really concerned about the quality of company reports, as many of them hide much more than they ever tell you. Do you feel that there is also a role there for further scrutiny? It seems to me that company reports are often meant to obscure rather than illuminate.

Daniel Godfrey: Without going into motivation, obviously, they could be. There is a real problem with company reports. The introduction of International Accounting Standards has unfortunately made things worse. Accounts should be there to provide information to owners—to users of the accounts. The last place you would go if you wanted to find out about the company now, almost, is the report and accounts.

Mr Binley: That is the problem.

Daniel Godfrey: So, yes, there is certainly scope for further scrutiny, and I am glad to see the FRC is now acknowledging that the introduction of International Accounting Standards has not perhaps improved the clarity with which people can understand the report and accounts, and that is greatly to be regretted.

Q274 Mr Binley: I understand that, but they also need scrutiny. I do not want to create a great big bureaucracy in the forum, but I do want to see some incisive thinking that really impacts on your clients.

Daniel Godfrey: We take corporate reporting and the quality of corporate reporting very seriously. We are very engaged in that. Whether it could become an adjunct of the forum or not, I do not have a view on at this stage. It certainly is an issue that investors need to be very engaged with, because it is clearly a huge amount of wasted time, effort and money to produce accounts that are of very little value, and it also provides disadvantage to investors who are not able to do work around the report and accounts to get a real understanding of companies.

Guy Sears: I do not think regulation would be the answer, and that is why the fora will hopefully be the answer. This will not be the only place in which we have documents that are legally comprehensive but utterly incomprehensible. That is a problem we get very often from regulation.

Q275 Mr Binley: So it is on your little list?

Daniel Godfrey: It certainly is.

Penny Shepherd: The area specifically of non-financial reporting—of environmental and social governance reporting—is an area on which investment managers have engaged with companies to improve performance over the last few years. But it is also an area where investors have worked with companies to set standards, so that you can have more comparable reporting. Ultimately it is not just about understanding the company; it is also about being able to compare it with its benchmarks.

Q276 Mr Binley: I understand that, so can I put words into your mouth? It would be better to have a sensible six-monthly reporting process, rather than a totally unreadable quarterly process.

Penny Shepherd: It is fair to say that quarterly reporting is on its way out. It has been recognised as a blind alley. If you look back at when the European Commission introduced quarterly reporting, it is interesting to see the positive effects it was expected to have. The fear is that, when the legal requirement for quarterly reporting is removed, companies will continue to do it if they get pressure from short-term investors to do so.

That is an area where long-term investors can play a positive role in saying, “No, we are not interested in the quarterly figures; we do not want you to focus on those. What we are interested in is the long-term story and, yes, key metrics but also forward-looking reporting around what you see as the key opportunities and threats for your business, and what you are going to do about that, so we can assess the quality of you as management and we can assess the likelihood that your strategy will succeed."

Matthew Fell: We agree that quarterly reporting does not add value and it should go. In terms of your question around annual reports obscuring the real story, I do not think there is a motive for companies to do that.

Mr Binley: I think sometimes there is.

Matthew Fell: I would disagree for annual reports, almost for the very reason that Daniel alluded to—that annual reports do not do anything to move markets at all now. It is not the place you go to really get into the report.

Q277 Mr Binley: Your comment is that you do not think they are sometimes written to obscure. I do not believe that to be true.

Matthew Fell: The major motivator there is a big sense of frustration. The sheer volume of stuff that is required to go in there turns them into doorstopper reports and makes it hard to find the data.

Mr Binley: You have a higher regard for some of your members than I do. Let us continue.

Matthew Fell: The third thing I would like to say on the narrative reporting is that a shift in that direction would be a really good thing for driving better engaged and better quality investment decisions.

The one thing I would say on Penny's remarks about the benchmarks and so on is it is very important that, if we do have this move towards narrative reporting, which would be a good thing, we make sure we do not get into a situation where companies have to report against particular benchmarks. The really important thing about narrative reporting is that companies are able to properly set out their strategy and investors can decide on that, and the different sort of emphasis that you will put in different narrative reporting could vary dependent on the nature of the company and the sector that you operate within.

Penny Shepherd: Briefly, I would add two issues. One is forward-looking narrative reporting. The other one is around key sector-specific metrics to assess companies, for example the health and safety metrics in the extractive industries. That is what I am talking about there when I talk about numbers.

Matthew Fell: You would put a bigger emphasis on companies in that environment.

Chair: You are in danger of having a discussion among yourselves.

Mr Binley: Thank you Chairman. I am just relieved that Daniel has got it on his little list, so we will see how that progresses.

Q278 Rebecca Harris: Penny, you commented that the way forward for Kay involves a lot more cross-departmental work on stewardship. What is your sense of the real level of appetite for change in Government?

Penny Shepherd: What I noticed with many Government consultations is that arguably there tends to be a focus on those organisations associated with the Government Department that has commissioned the review. So to give you one example, if we look back to the Walker Review that was commissioned by the Treasury and by the Financial Services Authority, which looked at the governance of banks and other financial institutions, what was quite noticeable was, yes, it commented on the governance of banks, but it did not talk about the governance of pension funds. Improved governance of pension funds is a significant driver of better capital markets. That is just one example.

If we look at the departments involved in this area, we have the FCA, the Financial Reporting Council, and The Pensions Regulator. We have DWP overseeing pension funds, the Cabinet Office overseeing charitable investment, and Communities and Local Government overseeing the Local Government Pension Scheme. This does not look like the most effective structure for getting things done. It would be very helpful if you were to look either at more co-ordination, at the future direction of relationships between regulators, or even at issues like centres of competence in Government to look at some of these issues, rather than having them spread so widely.

Q279 Rebecca Harris: The Government is proposing to publish a progress report in the summer of 2014, so less than 18 months away. What would you see as the absolute minimum that needs to have happened by then in terms of the Kay Review?

Daniel Godfrey: The industry needs, in whatever way, to step forward in a very substantive and principled way to advance the cause of long-termism. A part of that could be the investors' forum. A part of it could be the way in which investors engage on an individual basis. The point was made earlier by Matthew around the quarterly reporting, and in a sense that falls away as being an issue if investors are truly able to give boards the confidence that they are looking at them and measuring them on a long-term view.

We cannot ignore, and it would not be appropriate necessarily to demonise, different forms of investment management. But I think as a society and as a Government, what you want to encourage—because it is good for the economy and good, therefore, for the welfare of the citizens of this country—is a long-term approach and long-term investment. That is why this sort of hearing is very valuable, and so we need to step forward and give boards the confidence that they do not have to think over three-month timeframes and can take long-term decisions. This will drive the economic growth that you are looking for.

Guy Sears: I would only add that they are just layers and layers. Of course there are these high points, and then you have to ask whether they are individual barriers, and there are issues around conflicts of interest and the incentives that arise in our industry. I think Aviva mentioned the role of investment consultants in reviewing and determining these things over a short-term period.

In terms of the measure of success, I suppose we had hoped that, in terms of regulation and the duties expected, that would be coherent across that chain. So even if people think the chain is too long, it would at least be coherent. At the moment, different parts of it are either regulated or unregulated—different parts have different duties imposed on them.

Penny Shepherd: Looking at the demand side in summer 2014, what we have at the moment is some asset owners, like pension funds and insurance companies, supportive of the Stewardship Code and getting to grips with how they hold their investment managers to account. I certainly hope we see considerable progress in the thinking and development of that work.

More generally, I hope we see considerably more asset owners signed up to the Stewardship Code. It strikes me that there are particularly three groups that one would hope we would see considerably more progress on. First of all, we would hope to see pretty well every Government pension fund signed up to it. Secondly, we would hope to see considerably more corporate pension funds signed up to it, because one group that is notably absent in this area are the pension funds that are influenced by large companies. We are starting at last to see some movement on that, but there is still a considerable way to go. I would certainly hope the CBI would encourage their members to influence corporate pension funds, DB and DC, to have considerably more signatories to the Stewardship Code, and then effective implementation of that by summer 2014.

Finally, it would be so nice if by then the Parliamentary Contributory Pension Fund had signed up as well because, as of this moment, my understanding is they have not.

Chair: Thank you; that is very illuminating.

Q280 Katy Clark: Penny, you wrote that there is a clear role for Government to play in acting in a co-ordinated fashion to reform equity markets. Where do you think we are on that at the moment?

Penny Shepherd: One of the challenges of the Kay Review is that it has been commissioned by BIS, and ultimately the Government department with the greatest influence over equity markets is the Treasury through the FCA, and so ultimately one measure of success in that area is when we see the same level of commitment to long-term investment by the Treasury and its Ministers as we are currently seeing from BIS.

Q281 Katy Clark: In 2001, Lord Myners said that "it is important at least to attempt to seek an effective approach which does not rely on direct Government intervention in banning or directly determining behaviour". Ten years later, Professor Kay continues with that theme. Isn't it now time to formally regulate the market and, if so, which areas do you think more naturally lend themselves to formal regulation and which are better suited to voluntary compliance?

Guy Sears: The equity markets, just so we are clear, are subject to a massive amount of European-derived legislation through the dreaded MiFID, which is being revised at the moment. One of the difficulties with the regulation is it is designed around secondary market trading.

The real demand, I would suggest, in the thing we have been discussing is about primary markets—about raising capital. So we have driven ourselves through legislation and through incentives into a world in which the primacy of activity is secondary market trading. Kay and others have asked the question: where are the primary markets and where are those activities? That is a huge challenge on a pan-European basis, and it is a huge challenge that is going to be very difficult to address, because at the moment our whole focus really is on secondary market structures, things like high-frequency trading and the roles of alternative trading venues that London has and maybe continental Europe does not. From that point of view, that is very difficult.

If you then say the balance is between regulation and non-regulation, if I may be simple about it, good regulation ought to allow firms and participants to distinguish themselves—to show themselves as offering different service offerings from others but also to rise up in terms of standards. Getting that balance between prescribing, such that there is no difference in behaviour across the whole market because it is so prescribed, and opening up the market, so that you can compete more and show different offerings, is a very difficult balance.

To have that balance, we need to be trusted to ask for less regulation. We need to be trusted, and there is a trust issue with financial services generally. We need to move forward on that in terms of building confidence for us to then be able to turn round and say, "We do not need to be regulated so much."

Q282 Katy Clark: The point I was making is it is 10 years on—in fact, it is more than 10 years on. How much longer should you be allowed?

Daniel Godfrey: If you are talking about how we create more frequent and higher quality stewardship and engagement, almost any regulation you try to bring in will not have the impact you want it to have, because it is a very touchy-feely part of business: how you engage, what you derive from it, what actions you take as a result, and what happens to the companies as a result. We can put in place things that make it look like things are happening really easily through regulation, but real progress will come from belief—people believing it will work—and also pressure from the demand side because they believe it will work, and that is entirely achievable over a period of time. You have to start somewhere.

What you will get, and what you have already seen happening just in response to the pressure from Government, is the establishment of an industry around governance, some of which works very well but a lot of which is around box ticking and boiler plating, which frustrates the heck out of the CBI members, because they get guys coming to them with clipboards, and creates a fiefdom within asset management companies. Although some of it is done exceptionally well, some of it is really cost and time wasting, and does not produce the results you want. I can almost guarantee that, if you try to regulate this, you will just get more of that.

Penny Shepherd: One of the things that John Kay calls for are effective incentives that encourage the investment chain to do the right thing. What we think he is rightly very concerned about is rules that seek to force compliance when actually the interests of the members of the investment chain run counter to complying. That creates a market in pretending to do things and not getting caught. In a way the danger has been over the last few years that the incentives have been to not get caught, rather than actually to do the right thing.

Creating a market in doing the right thing comes down to two particular things. One is the quality of demand and addressing the quality of demand, and the other one is ensuring effective innovation and effective competition in the market. One of the worst things that could happen is the creation of a barrier around the market, so that only the current players can afford to play and new people find it difficult to come in and challenge them because of the way the regulation of the market has been set up.

Matthew Fell: I agree with much of that. On the balance between regulation and advocacy, if the task in hand is really to drive up high-quality engagement, I struggle to see how you actually generate those sorts of conversations through regulation, for all the reasons that Daniel outlined.

Chair: That concludes our questions. Thank you very much. I repeat what I said to the previous panel: if we feel on looking at the transcript that there are further questions we would like to ask you, we will write to you and would be grateful for a reply. Similarly, if you feel there are questions we should have asked you but did not, feel free to give your response in absentia. Thank you very much.