

Prof. John Kay  
The Kay Review  
Department for Business, Innovation and Skills  
Spur 1, Floor 3  
1 Victoria Street  
London SW1H 0E

24 April 2012

Dear Professor Kay,

Thank you for the opportunity to comment further on your review of the UK Equity Markets. We respect your wish not to receive information already submitted and will therefore comment on just a number of areas where we feel it is sufficiently important to express our views.

**Expectations on asset managers:** We do not believe that asset managers are currently able to fulfil the expectations being heaped on them for good stewardship. Currently the asset management industry as a whole is woefully short of the resources it needs to be good stewards. It is helpful that the Review recognises that there is a lack of incentive for engagement (an essential part of good stewardship). However, the problems go beyond incentives and there are very real barriers throughout the investment chain that prevents each part of the chain, including asset managers, from becoming better stewards.

In order to help remedy this situation there are a number of steps that we feel needs to be taken as follows:

**Identify and manage the inappropriate incentives and numerous conflicts of interests** that exist along the investment chain. These barriers prevent asset managers as well as all the others in the investment supply chain (all the intermediaries) from focusing on returns to savers and on the performance of companies which the Review identifies as the purpose of equity markets. There needs to be a systematic analysis of what these inappropriate incentives and conflicts are and how these might be addressed. Without such a review, the barriers that exist along the chain will prevent the market from becoming more long term and will prevent asset managers from fulfilling their stewardship roles. For example, (a) investment consultants are incentivised to change asset managers through their incentive arrangements which reward change more than it rewards stability. This means that the asset manager is under pressure for short term performance. (b) Brokers who have corporate clients may be encouraged not to publish a negative report on those clients. As a result, relevant information is not being received by asset managers who may not, therefore, be aware of concerns and are unable to act upon them. This is, in our view, a major reason why asset managers, as an industry, does not consider governance and sustainability issues as a matter of course. (c) Remuneration consultants act for boards or remuneration committees and are therefore incentivised to ratchet up pay (perhaps the Labour Party's proposed amendments to the Financial Services Bill that remuneration consultants should be appointed by shareholders should be considered). There are many more situations such as these that should be addressed if things are to change. Aviva Investors is working with Tomorrows Company on such an investigation but the work has not yet been completed.

**There should be a body to whom professionals within the investment chain can "whistle blow" when asked to do anything against the spirit of their profession or when they are aware of unprofessional conduct.** Just like doctors can be reported to the British Medical Association, a body should be set up for those working in asset management firms, investment consultants, remuneration consultants etc who do not have a natural professional body to whom to report and/or discuss inappropriate behaviours. This should help to address the conflicts that are so endemic within the industry. So for example, if a sell side analyst has been pressured to

put a positive recommendation out, contrary to his own view, because the report is on one of the firm's clients, then such behaviour should be reportable. There should be penalties for poor behaviour e.g. doctors get struck off. So the broker who changed his view for his own firm's commercial reasons and the person who applied the pressure may be censured, fined or prevented from working in the profession.

### **Need to create demand for stewardship from clients of asset managers**

The review stresses the importance of asset managers and stewardship in facilitating changes in the equity markets and does recognise the lack of incentive for engagement. However, the Review says that this is "an inescapable feature of an investment landscape characterised by competitive fund management industry and the fragmented holding of shares" We do not agree that this is an "inescapable feature".

There are many reasons why asset managers do not engage or are good stewards. Many of these are reflected in the Review. However, one of the major reasons is that clients of asset managers do not care. If we can create the demand from clients, asset managers will put in the resources, time and effort to be good stewards. There are several things that can be done to create more demand.

For example, currently pension funds only need to say in their Statement of Investment Principles (SIPs). The only requirement of pension funds is to state in their Statement of Investment Principles "the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments. In short there is NOTHING that compels a pension fund to do more than say the above in the SIP. Suggestions include requiring Pension Funds to state in their Statement of Investment Principles, whether they take the Stewardship Code into consideration and if not, they need to explain why not.

Very importantly, pension funds should provide information to their members on their approach to stewardship. Similar disclosure requirements could be imposed on insurance company funds, life funds, insurance funds and retail funds such as OEICs so retail investors know whether their fund managers believe in good stewardship. Such transparency and justification for their positions should encourage funds to consider their approach and is likely to encourage more long term and sustainable outlook.

Similarly, other participants in the chain such as investment consultants that advise pension fund trustees should disclose what their approach is on long termism, stewardship and sustainability issues and how they promote these matters and if they don't, why not. Also, brokers should be required to have a view on the long term strategy of companies, the quality of management and highlight material sustainability issues in their reports.

Although this sounds draconian, all the links in the chain need to work together for things to change. We do not believe that just focusing on asset managers will do the trick.

**2020 Stewardship:** In order to allow prospective interested clients to compare the stewardship capabilities of asset managers, a group of UK institutions came together with Tomorrows Company and produced a report 2020 Stewardship. Within this document is a matrix that we believe all asset managers should complete and attach to their stewardship statements on their website and on the FRC's website so that potential clients are able to easily compare the approach and capabilities of each asset manager. This should ease the whole process of identifying appropriate asset managers who would be able to meet client requirements in this space.

There are other suggestions within the paper, one of which is for companies to evaluate the quality of the asset managers on engagement. This may be done through better practice and use of feedback mechanisms in a systematic way after engagement has taken place or, for example, the Investor Relations Society could report each year on the asset managers that have been most positively "mentioned in despatches".

**Fiduciary duties:** Other suggestions already made in previous responses will also help. For example, we support the extension of fiduciary duties as proposed by FairPensions. FairPensions believes that the uncertainty around the fiduciary duties of pension fund trustees and other investment professionals is a barrier to funds being able to consider longer term sustainability issues. We agree with FairPensions. We believe that if fiduciary duties are clarified to the extent that pension funds (and others) can look beyond financial returns over the short term, then it will encourage greater involvement with companies and there will be more incentive for pension funds and, therefore, asset managers to consider longer term issues.

**Differential voting rights:** However, we do not believe that promoting long termism through differential voting rights will lead to better returns for savers or necessarily improve the performance of companies. If, as the report says, stewardship is central to improving the equity markets and it is the only way in which the financial services sector can discharge its responsibilities to those who entrust funds to it, then, in many instances, differential voting rights will diminish the power of shareholder to fulfil this function.

Other than the principled reason that shareholders should be treated equally, the reasons are many and varied. For example, the existence of differential rights generally devalues the overall market capitalisation of a company's equity and, by implication, ascribes a lower present value to the long-term prospects of the company. It is likely to make companies less responsive to investors, especially if there are long term majority owners linked to the board. It will entrench boards and allow them to ride roughshod over minority shareholders if they so wished. The practicalities of identifying which stock holds which number of votes will be a logistical problem. We believe the dangers outweigh any potential benefits and do not believe the costs and problems related to differential voting rights justifies the (unlikely) benefits to savers and companies.

Yours sincerely

Steve Waygood  
Chief Responsible Investment Officer  
Aviva Investors