Investment Management Association

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Business, Innovations and Skills Committee
The Kay Review of UK Equity Markets and Long-Term Decision

Memorandum by the Investment Management Association[1]

EXECUTIVE SUMMARY

ES.1. The asset management industry plays a vital role in allocating capital from those that want to invest to those that need investment capital. This is important to the achievement of the Review's vision in creating growth and jobs, and whilst much is said about the loss of trust in the intermediation of the markets, the UK asset management industry remains strong. It saw a 5.1 per cent increase in assets under management in the year to December 2011 from 2010, and 23 per cent from 2009[2].

ES.2 As an agent, an asset manager has a fiduciary responsibility to its clients, as well as responsibilities derived both from contractual agreement and regulation. Combined with fee structures, these elements help to ensure that the manager acts in the client's best interest. In this context, IMA supports stewardship – it is important for ensuring good outcomes for clients. Our members are increasingly pursuing good corporate stewardship in achieving better outcomes. However, an asset manager acts as an agent for its clients and we do not support such matters being prescribed such that the terms of asset owners' mandates with managers are constrained. Moreover, while long-term holdings will tend to form a core part of portfolios, holding periods for individual stocks and securities will inevitably vary. The important thing is that asset managers continue to deliver value for their clients. Nor do we consider an asset owner should be ascribed a societal role in determining the terms of their mandate.

ES.3 We set out below our evidence on Kay's Recommendations and the Government's Response. In places we distinguish between "fund managers" operating pooled funds such as UK Authorised Funds (unit trusts and open-ended investment companies) which pool money from many clients in the same vehicle; and "investment managers" that have discretionary management of assets for individual clients according to segregated mandates. We refer to the two together as "asset managers".

[1] IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of approximately £4.2 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, the Annual IMA Asset Management Survey shows that IMA members managed holdings amounting to 34% of the domestic equity market.
[2] Page 14, Asset Management in the UK 2011-2012, the IMA Annual Survey. http://www.investmentfunds.org.uk/research/ima-annual-industry-survey/

Recommendation 1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance

1.1 IMA supports this Recommendation and, as noted in the Government's response, it has already been addressed in the Financial Reporting Council's revised edition of the Stewardship Code which was published in September 2012 and came into effect on 1 October 2012.

1.2 Over the last three years, with a steering group chaired by the FRC, IMA has looked at institutional investors' activities that underlie their policy statements drawn up under the Code. Our first report looked at the position as at 30 September 2010[3], our second to 30 September 2011[4] and we plan to issue our third to 30 September 2012 in the first part of this year.

1.3 The second report summarised 83 responses to a questionnaire sent to 173 signatories as at 30 September 2011. The 58 asset managers that responded managed £774 billion of UK equities, representing 40 per cent of the UK market, and the 20 asset owners owned £62 billion (five Service Providers also responded but do not manage or own equities for investment purposes).

1.4 To gain a better understanding of the issues that give rise to engagement, respondents were invited to indicate the number of companies they engaged with on particular issues. This demonstrated that a company's strategy and objectives are clear priorities in that respondents engaged with 1,611 companies on these issues. This compares to more conventional corporate governance matters and engagement with 1,754 companies on remuneration issues (these are subject to a specific vote) and 1,039 companies on board diversity/committee membership. A similar ranking is evidenced in the third draft report which is still being collated.

1.5 Moreover, in seeking to establish a mechanism for collective engagement (see press release at http://www.investmentfunds.org.uk/press-centre/2012/press-release-2012-11-22) one of our premises is that intelligent engagement with companies on strategy can help secure better long-term sustainable returns for shareholders. Governance and remuneration issues are important in so far as they underpin the achievement of that strategy (see Recommendation 3 below).

Recommendation 2. Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should takes steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements

2.1 IMA supports market-led solutions and in principle, the proposed Good Practice Statements for asset managers, asset owners and company directors seeking to emphasise the need for trust-based relationships.

2.2 However, many of the points in the proposed Good Practice Statement for asset managers are already addressed in regulation. For example, all regulated firms are subject to the Financial Services Authority's "11 Principles" which include

[3] http://www.investmentfunds.org.uk/research/stewardship-survey
[4] http://www.investmentfunds.org.uk/assets/files/surveys/20120612-stewardshipcode.pdf

requirements to:

- conduct business with integrity, and due skill, care and diligence;
- pay due regard to clients' interests and treat them fairly;
- pay due regard to clients' information needs and communicate information which is clear, fair and not misleading;
- manage conflicts of interest fairly, both between the firm and its clients, and between individual clients; and
- take reasonable care to ensure the suitability of advice and discretionary decisions for any client that is entitled to rely on the firm's judgment.

It is also a European requirement, first implemented in the FSA Handbook from 1 November 2007, that asset managers must act honestly, fairly and professionally in accordance with the best interests of their clients (and now in the case of a fund manager, the fund it manages). These requirements largely address the first three points in the Statement.

2.3 Other rules provide greater specificity in particular areas. For example, as regards "adhering to the investment strategy agreed with clients[5]", suitability requirements[6] seek to ensure an asset manager obtains information to understand the essential facts about their client and has a reasonable basis for believing that transactions in the course of managing that client's assets meets the client's objectives.

2.4 Specifically, the information on a client's objectives must include, where relevant, the length of time the client wishes to hold the investment, their attitude to risk and risk profile, and the purpose of the investment. A client's, the asset owner's, time horizons, investment objectives and strategy may vary. Thus an asset manager may not be able necessarily to prioritise "medium to long-term value creation and absolute returns[7]" and make "investment decisions based on judgments about long-term company performance[8]". It is not a given, for example, that an asset owner wants an absolute return investment objective.

2.5 Similarly as regards asset managers building an "on-going relationship of stewardship with the companies they invest[9]", it is an FSA Conduct of Business requirement that asset managers (with professional clients) have a statement of their commitment to the FRC's Stewardship Code or explain their alternative strategy[10]. This, and the "comply or explain" approach to the Code itself, recognises the agency nature of asset management and that as fiduciaries acting on behalf of clients, managers offer a choice. In operating in the best interests of its clients, see

[5] Point 6 in the Good Practice Statement.
[6] Financial Services Authority Conduct of Business Rule 9.2.1, (1) firm must take reasonable steps to ensure that a personal recommendation, or a decision to trade, is suitable for its client. (2) When making the personal recommendation or managing his investments, the firm must obtain the necessary information regarding the client's: (a) knowledge and experience in the investment field relevant to the specific type of designated investment or service; (b) financial situation; and (c) investment objectives; so as to enable the firm to make the recommendation, or take the decision, which is suitable for him.
[7] Point 7 in the Good Practice Statement.
[8] Point 9 in the Good Practice Statement.
[9] Point 8 in the Good Practice Statement.
[10] Financial Services Authority Conduct of Business Rule 2.2.3 which was effective from 6 December 2010. This requires that an asset manager acting for a professional client that is not a natural person must disclose clearly on its website, or if it does not have a website in another accessible form: (1) the nature of its commitment to the Financial Reporting Council's Stewardship Code; or (2) where it does not commit to the Code, its alternative investment strategy.

2.2 above, an asset manager may want to divest a holding if clients' interests cannot be protected through stewardship and we are concerned that it is often implied that asset owners and managers have a societal role that requires them to engage with companies.

2.6 Moreover, both long-term value creation and stewardship are more immediately relevant to equity markets. Both asset managers and asset owners will have market exposures far wider than equities and which are international.

2.7 Care, therefore, is needed to place Good Practice Statements[11] into their appropriate context and in ensuring that they are not unduly constraining for asset owners and asset managers, and the terms of any agreed mandate. Notwithstanding this, IMA has been a long-standing supporter of the stewardship agenda and our members are increasingly pursuing considered corporate stewardship in achieving better outcomes for clients. We set out in Annex 1 how this role has been transformed over the last decade. We are also a member of the Institute of Chartered Secretaries and Administrator's steering group referred to in the Government's response[12]. This is developing a good practice guide to improve the quality of engagement and aims to identify more effective means for companies and institutional investors to provide feedback on meetings.

Recommendation 3. An investors' forum should be established to facilitate collective engagement by investors in UK companies.

3.1 IMA agrees that it may be helpful to establish an investor forum or mechanism to facilitate collective engagement. Whilst we recognise there are already a number of ways in which groups of investors come together, we believe there may be a need for a mechanism, which is open to the broadest possible range of shareholders in a particular company to take collective action, in instances when individual engagement has failed. We believe it important that any such initiative is investor/shareholder led and are currently engaging with the investment community in completing a series of meetings in order to determine the best means of taking this forward. We are also keeping BIS officials up-to-date with developments.

3.2 Whilst we have certain ideas, we want an open discussion in order to be able to develop a solution that will be effective and which is supported - see Annex 2. We believe that any solution should elevate the importance of investor understanding and engagement with a company's strategy for the delivery of sustainable, long-term shareholder value. Wider governance and remuneration issues are important in so far they underpin the achievement of that strategy. Some of the issues that have been identified to date during our discussions include:

- any mechanism to be effective needs to ensure, either through a Code of Conduct and/or Non-Disclosure Agreements, that discussions are kept confidential;
- concerns about the creation of price sensitive information with the concomitant trading restrictions need to be addressed; and
- concert party concerns which appear particularly to be an issue for US investors.

[11] Points 4, 5, 10 and 11 in the Good Practice Statement repeat Recommendations 8, 10, 3 and 16, respectively. Our observations are set out under the relevant Recommendation.
[12] Page 19.

3.3 As noted, we want any such mechanism to be investor-led, but, if sufficient support can be secured, we are committed to providing it with resource and funds as necessary. We are discussing our proposals with other trade associations, such as the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF), and are including them in our meetings with investors and keeping them up-to-date with our thinking as it develops.

Recommendation 4. The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves

4.1 This is outside IMA's remit.

Recommendation 5. Companies should consult their major long-term investors over major board appointments

5.1 In principle, IMA agrees that companies should consult their major investors over major board appointments. In the main this already happens and investors welcome it particularly when a company is considering changes at a time when the company concerned is in difficulty or to key roles such as chairman or chief executive. But we do not believe investors or companies necessarily want to be consulted on every appointment or that this should be mandatory - neither has the resource to do so and it could undermine the role played by the nominations committee. We also question what is meant by "long-term" investors. Asset managers provide their clients with an investment service and adopt varying strategies to meet specific mandates. While long-term holdings will tend to form a core part of portfolios, holding periods for individual stocks and securities will inevitably vary.

5.2 In the event a company makes an appointment that investors do not believe is appropriate, each new appointment has to be ratified at the Annual General Meeting and it is a provision of the UK Corporate Governance Code that all directors of FTSE 350 companies are subject to annual re-election by shareholders[13].

5.3 Moreover, when signatories to the Stewardship Code indicated the number of companies they engaged with on particular issues, see paragraph 1.4 above, executive remuneration and company strategy/objectives, were closely followed by board diversity/committee membership (1,039 companies).

Recommendation 6. Companies should seek to disengage from the process of managing short term earnings expectations and announcements

6.1 As set out under Recommendations 11 and 15, quarterly reporting and executive remuneration structures, respectively, can result in too much focus on the short-term meaning that companies can lose sight of their long-term objectives for development of the business and can result in value destruction. We consider these matters should be addressed.

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[13] Provision B.7.1. B.7.1 and B.7.2 also expect the papers accompanying a resolution to elect or re-elect directors to set out the following: sufficient biographical details to enable shareholders to take an informed decision; why they believe an individual should be elected; and on re-election confirmation that, following formal performance evaluation, the individual's performance continues to be effective and demonstrates commitment.

Recommendation 7. Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.

7.1 We do not consider the proposed new standard is needed given existing regulation (of which much is at EU level). We set out at Annex 3 our paper on the relationship between fiduciary duty, contract and regulation that we submitted to Government (this addresses segregated mandates). As we explain in this paper and our submissions to the Kay Review, we do not consider that existing regulation acts as an impediment to asset managers using a long-term approach where the client expresses such an objective.

7.2 Even if there could be a restatement of fiduciary obligations consistent with EU law, IMA considers that the current rules impose very high standards. It is still unclear to us what is deficient with the current requirements for asset managers; if trustees are fearful of suit or the law applying to them is unclear, then that is a different issue. The investment manager's role is to follow the mandate it is given by the client; the fund manager to follow the objectives of the fund prospectus.

7.3 We do not see the need for the UK to move away from the EU standard, even if it could make a case to do so. Additionally, and without prejudging any Law Commission work – see Recommendation 9 below - we do not consider it would be sensible from the viewpoint of the UK's competitiveness to prohibit contractual modification of a range of, sometimes disputed, statements of fiduciary responsibility, developed through case law in many areas of business. It is essential that services can be tailored to the needs of global investors serviced from the UK, especially where the investor concerned has no interest in UK equity investment. Annex 3 explains our position.

Recommendation 8. Asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund

8.1 The asset management industry is committed both to high standards and consistency of disclosure. Detailed parameters for disclosure by investment and fund managers of charges for services (including performance fees) and transaction costs incurred in delivering those services are set out in both regulatory requirements and industry codes and guidance. We set out below the requirements for investment managers' segregated mandates and fund managers' pooled funds.

Segregated mandates

8.2 Disclosure to one of the most significant client groups using segregated mandates, occupational pension schemes, is covered by the IMA's Pension Fund Disclosure Code. This was first produced in 2002 by a group of investment managers, pension fund trustees and investment consultants, and has been endorsed by the NAPF's Investment Council.

8.3 The Code's objective is to promote investment managers' accountability to clients through increased transparency and to assist pension fund trustees' understanding of the charges and costs levied on the fund's assets for which they are responsible.

It provides a comprehensive, clear and standardised form of disclosure that allows trustees and their advisers to monitor and compare all costs incurred during the management of their fund's assets.

8.4 The Code has been updated twice, in 2005 and 2007, to accommodate disclosure requirements under the FSA's Use of Dealing Commission regime, and also to bring it into compliance with the execution provisions of the Market in Financial Instruments Directive 2004/39/EC (MiFID). It operates on two levels.

- Level 1 is a description of house policies, processes and procedures in relation to the management of costs incurred on behalf of clients and, in respect of new provisions brought in by MiFID, appropriate information on the investment manager's execution policy. This is particularly relevant for the disclosure of implicit costs where they cannot be measured accurately e.g. transaction costs.

- Level 2 is client specific information. This requires disaggregation of transactions by counterparties and disclosure of commissions on those transactions and services received in exchange for those commissions. Additional commentary is provided where this helps put numerical disclosure into context. It also requires managers to disclose, in percentage terms, the firm-wide pattern of trading, and the sources and uses of commissions overall in the relevant asset class and to compare that to the specific client.

  In addition, Level 2 requires disclosure of other costs e.g. fund management fees and other income derived by the manager and associates, underwriting/sub-underwriting commissions, stock-lending income to the fund and the associated fees, VAT, stamp duty and any other transaction taxes and levies.

8.5 The latest version of the Code is at: *Pension Fund Disclosure Code - September 2007.*

Pooled Funds

8.6 A version of the Pension Fund Disclosure Code applies to pooled funds that are UK Authorised Funds. This is the CIS Disclosure Code, jointly issued by the IMA and the Depositary and Trustee Association (DATA), and is intended to provide a similar level of accountability and transparency with respect to transaction costs to that provided by the Pension Fund Disclosure Code. However, the CIS Code is not a consumer document, but intended to be used by fund trustees and depositaries with specific oversight responsibility for Authorised Funds. It is available on request.

8.7 The majority (around 85 per cent of total funds under management) of UK Authorised Funds are regulated under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directives. These are governed by the Key Investor Information Document (KIID), which ensures that charges (including performance fees) are disclosed in a transparent and consistent manner. The KIID does not cover transaction costs, which have traditionally been disclosed in a fund's report and accounts which are available to all investors. However, IMA considers that for retail investors in particular, there is a need to make transaction costs more accessible. After consultation, IMA issued Enhanced Disclosure Guidance in September 2012, which both addresses the accessibility of transaction cost data and aims to achieve greater consistency in charge disclosure. The latest version is at:

Enhanced Disclosure Guidance. IMA is also supporting work in the pensions industry seeking to develop greater consistency of disclosure both for workplace scheme decision-makers and for consumers[14].

8.8 Some have suggested that charges and transaction costs should be combined into a single number. IMA strongly disagrees with this and believes a single metric would be misleading since charges and costs are fundamentally different and behave in different ways. Charges are paid for a service undertaken on behalf of an investor. Transaction costs (including taxes such as stamp duty) are necessarily incurred in the management of the portfolio in delivering the investment objectives. They are not paid to a manager, but arise when buying and selling investments in the market.

8.9 For example, take two equity funds – Fund A has an on-going charge of 0.5 per cent and turns over 10 per cent of its portfolio during a one year period. Fund B has an on-going charge of 0.5 per cent and turns over a quarter of its portfolio over the same period. Which is more expensive? In reality, both charge the same for the service, but only the performance will tell you whether the transaction costs had a positive result on the final outcome. A manager cannot hide from poor performance and a poorly performing fund manager will receive lower income via ad valorem charges – there is no incentive to over-trade to the detriment of performance.

8.10 In summary, IMA believes that both charge and transaction cost information should be readily available to investors to help them understand what they paying a manager and the manager's costs in providing that service. Combining figures would not be meaningful.

Recommendation 9. The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers

9.1 Asking the Law Commission to undertake such a review will mean that it will be subject to an open and transparent consultation process. We welcome this approach and the opportunity to provide input. In this respect, the Law Commission undertook sound work on fiduciary duties in financial services in the mid-1990s.

Recommendation 10. All income from stock lending should be disclosed and rebated to investors

10.1 Stock lending generates incremental returns for portfolios contributing to the overall investment performance. IMA supports consistent transparency of stock lending and the associated income to end-investors so that they have a clear view of the revenue earned and the amount retained by the lending agent. Indeed, in 2005, IMA introduced accounting requirements under which managers of UK Authorised Funds were required to disclose the gross amount of fee revenue generated from stock lending, in addition to the amount received by the fund, the value of stock on loan and the nature and value of collateral held as security. However, we do not agree that all income should always be rebated.

[14] This work has involved both the NAPF, which has now published a joint industry code on disclosure to employers, and the ABI, which is currently considering how to improve consumer disclosure.

10.2 Stock lending seeks to minimise the potential risks to the end-investors in that multiple counterparties are used, there is over collateralisation and contractual indemnification against losses from borrower default. These activities come with a cost to the lending agent - counterparties and collateral parameters are continuously reviewed, and settlement and corporate actions monitored. The lending agent provides trading expertise, economies of scale and risk controls across all clients that lend their stock. Moreover, whilst a high proportion of stock lending is through automated programmes, these require significant investment in systems and technology.

10.3 The model established by end-investors and the stock lending industry is that the lending agent receives a percentage of gross revenues to cover the costs of the service. The agent is only compensated if revenue is generated and thus the end-investors' interests are aligned with those of the lending agent.

10.4 UK Authorised Funds have been permitted to conduct stock lending only on the basis it represents no or minimum risks for investors in these funds. This risk to end-investors is minimised by Regulation which requires full collateralisation of exposures with highly liquid assets.

Recommendation 11. Mandatory IMS (quarterly reporting) obligations should be removed.

11.1 IMA supports this Recommendation and the fact that the existing EU requirement for interim management statements is being removed. There is a broad consensus in the UK that the re-introduction of a quarterly reporting requirement would be unhelpful on the basis that it can incline companies to focus on the short term.

Recommendation 12. High quality, succinct narrative reporting should be strongly encouraged.

12.1 IMA supports this Recommendation. Investors are increasingly concerned about the length, clarity and focus of annual reports in that reporting has become increasingly complex. In particular, the narrative information in the 'front half' of an Annual Report and Accounts could be presented more clearly and the accounts as whole could be more cohesive. For too many organisations, reporting is seen as a legal compliance process, rather than as a process for communicating what matters. This shopping list approach makes it more difficult for companies to deliver real strategic thinking and close the gap between the transparency provided by those companies that genuinely think long-term and those that do not.

12.2 Investors want material strategic issues disclosed not the issues per se. We support Government's proposals in this area[15] and the FRC's current discussion paper 'Thinking about financial reporting disclosures in a broader context[16]'. However, in general IMA believes the detail of narrative reports is best developed by market practitioners, the preparers and users of the information. This is a role that could be fulfilled by the FRC's Financial Reporting Lab which aims to provide an environment

[15] Page 6 of the Government's response.
[16] http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/October/FRC-publishes-paper-to-enhance-disclosure-in-finan.aspx

where investors and companies can come together to develop pragmatic solutions to today's reporting needs.

Recommendation 13. The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations

Recommendation 14. Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment

13.1 As regards, Recommendations 13 and 14, the asset management industry is varied and models and metrics develop. We consider regulators, including for IMA members the Financial Conduct Authority, are well placed to conduct thematic reviews of such matters and are bound to have noted and be considering these Recommendations. In this context, some of our members are concerned about the tendency of regulators to prescribe "one size fits all" and require substantive evidence. Nor do we believe Government would necessarily be the appropriate body for such specialised and interactive work.

Recommendation 15. Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business

15.1 Incentive structures for executive directors in the listed sector are an important driver of behaviours and in principle, IMA supports this Recommendation. Investors want companies to have remuneration policies that are aligned with their interests such that they promote long-term value creation, take account of the fact that effecting change to a company's strategy takes time, and mirror a company's development cycle.

15.2 Too frequently remuneration structures are based on short-term earnings and share price. Even long-term incentive plans (LTIPs) rarely extend beyond three years. Also, benchmarking executive remuneration to the size of the business creates a motive to acquire businesses to boost directors' earnings. There are a number of examples of acquisitions which in the long-run destroyed value. The short tenure of certain executives can compound this in that it is often not long enough to see the rewards from an investment. Certain authors have argued that a focus on earnings has given wrong incentives to management and that alternative metrics should be considered[17].

15.3 We welcome the improvements that Government is making in improving transparency so that a company's future pay policy is clear and easily understood, and that there is a clearer link between pay and a company's strategic objectives and performance. The policy report is to look forward and be subject to a triennial binding vote unless the policy changes. The implementation report looks back on how the policy was effected in practice and is to be subject to an annual advisory vote.

[17] https://secure.cfauk.org/assets/2162/CFAUKDBIS_Long_Term_responseSENT.pdf

15.4 Undoubtedly the time horizons over which management is incentivised need to be addressed. However, our preference would be for the Recommendation to set out the principles that should underlie any long-term incentive plans rather than prescribe they should be by way of shares – shares are an effective way to incentivise long term performance, but are not the only way. Moreover, requiring executives to hold the shares until after they have retired could result in them leaving a company when they consider it the best time to realise those shares. Certain of our members consider that a suitable compromise between career shares and the current standard practise for three year LTIPs would be five year LTIPs. There need not necessarily be a five year vesting period but at a minimum, there should be a period of at least five years between the date of grant of the award and any sale of shares. However, in general we believe, the Government's changes should be given time to take effect before further measures are considered.

Recommendation 16. Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund

16.1 If asset managers are listed they are subject to the same requirements as the listed sector. In any event they are regulated entities supervised by FSA. The FSA has set out clear principles in its Remuneration Code, which derives from European legislation. It applies to investment managers regulated under MiFID and is to be extended to fund managers under UCITS and AIFMD. European law requires firms to apply 'remuneration policies, practices and procedures that are consistent with and promote effective risk management'. Thus remuneration has to be aligned with the risks of the firm and Code Staff pay has to be disclosed. We do not believe there is a case for further regulation.

16.2 Specifically an individual portfolio manager's performance may commonly be assessed on a medium to long-term basis, with other factors such as client satisfaction, attitude to risk, and the extent to which the employee is a team player taken into account. For example, for an individual fund managers' remuneration, the basic/fixed part is around 30 to 40 per cent of the total and the performance part is around 60 to 70 per cent, of which a significant amount is deferred over two to four years. As well as bonuses being deferred they are also subject to claw back arrangements where targets are not met. To quote various asset managers:

- "[Our] remuneration policy is team based and 75-80 per cent of bonuses is paid in shares and has a three year vesting period. There is therefore no incentive to focus on one year's performance."
- "[We] are increasingly charging performance fees, which are based on at least a year-on-year performance. Remuneration of individual fund managers is based on a mix of team, fund and individual performance (roughly a third each) and no changes have recently been made to this policy."
- "There is no linkage with fees and short termism if they are calculated on an ad valorem basis. [It] does have some funds with performance fees which are calculated each year. Where there has been some underperformance however

the fund has to get back to its starting position before any subsequent outperformance can be rewarded. [It] believes this aligns them with the client and as they are building a long term relationship does not lead to taking risks in the short term."

- "[We] have no remuneration structures whether for managers or the company, which incentivize an increased turnover of securities."
- "[Our] individual asset managers have their remuneration linked to 1 and 3 year performance cycles."

16.3 While the level of fees has an impact on performance, individuals are paid by the firm, not by the client, so that decisions about an individual's remuneration do not affect the cost to clients. In any event, due to the way the industry is remunerated asset managers', companies' and clients' interests are aligned. The better the company does, the better clients and asset managers do. Whilst providing a performance incentive in the form of an interest in the fund to be held at least until the portfolio manager is no longer responsible for that fund may be conceptually attractive, it could encourage a portfolio manager to leave at a time when their particular fund is performing well for clients and in many asset managers, it is not an individual portfolio manager that is responsible for a particular fund.

Recommendation 17. The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.

17.1 Whilst we would welcome Government exploring the cost of intermediation to investors so that they can hold shares directly on an electronic register, this matter is being looked at as part of the proposed EU Securities Law Directive.

Stewardship

IMA has been a long-standing supporter of the stewardship agenda. We firmly believe many clients of asset managers expect stewardship responsibilities to be taken seriously when delegated to the manager, and those managers should and do respond to this.

It is also clear that this stewardship role has been transformed in the last decade. In 2002, investors gave new impetus to stewardship and the Institutional Shareholders' Committee (ISC[18]), whose members, including IMA, represent virtually all UK institutional investors, issued the Statement of Principles[19]. This was the first comprehensive statement of best practice governing the responsibilities of institutional investors in relation to the companies in which they invest on behalf of the ultimate owners.

IMA benchmarked the industry's adherence to the Statement of Principles through regular surveys. Starting in 2003, these clearly demonstrated that engagement was evolving and becoming more transparent. The last survey to 30 June 2008 showed that 32 asset managers that managed equities amounting to 32 per cent of the UK market actively engaged, voted their UK shares, and increasingly published their votes[20].

Nevertheless, institutional investors recognised that in the run up to the financial crisis there were failings in their scrutiny and challenge to banks' strategy and excesses, and that they needed to address this. The ISC took steps to do so and reissued the Statement of Principles as a Code in November 2009, modifying it to seek to improve the dialogue between institutional investors and companies.

The Government at the time wrote to the FRC asking it to adopt the Code and, following a public consultation, the FRC issued it as the Stewardship Code in July 2010. In December 2010, the FSA made it a requirement that authorised asset managers disclose publicly their commitment to the Code or their alternative business model. This aimed to ensure that those that appoint asset managers are aware of how a manager exercises its stewardship responsibilities, if any. The Code also expects those that commit to it to report to their clients/beneficiaries on how they have exercised their responsibilities and to have a public policy on voting disclosure.

It is important that this transparency is supported by practice. Over the last three years, under the direction of the FRC, IMA has looked at institutional investors' activities that underlie their policy statements drawn up under the Code. Our first report looked at the position as at 30 September 2010[21], our second to 30 September 2011[22] and we plan to issue our third to 30 September 2012 in the first part of this year.

The second report summarised 83 responses to a questionnaire sent to 173 signatories as at 30 September 2011. The 58 Managers that responded managed £774 billion of UK equities, representing 40 per cent of the UK market, and the 20 Asset Owners owned £62

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[18] The members of the ISC were: the Association of British Insurers; the Association of Investment Companies; the National Association of Pension Funds; and the Investment Management Association. In 2010 this was reconstituted as the Institutional Investor Committee made up of the Association of British Insurers; the National Association of Pension Funds; and the Investment Management Association

[19] http://www.investmentfunds.org.uk/press-centre/2002/20021021/

[20] http://www.investmentfunds.org.uk/press-centre/2009/20090520-01/

[21] http://www.investmentfunds.org.uk/research/stewardship-survey

[22] http://www.investmentfunds.org.uk/assets/files/surveys/20120612-stewardshipcode.pdf

Stewardship

billion (five Service Providers also responded but do not manage or own equities for investment purposes).

The report clearly demonstrated progress. For example:

- as at 30 September 2011 173 institutional investors had committed to the Code up from 80 as at 30 September 2010;
- all of the 2011 respondents now have complete policy statements on how they exercise their stewardship responsibilities whereas in 2010, six respondents only had a statement of their intention to produce one;
- in 2011, more of the 2010 respondents have client mandates that refer to stewardship;
- the 2010 respondents increased their resources responsible for stewardship by 4 per cent in 2011;
- the proportion of votes cast increased in all markets in 2011; and
- a greater proportion of respondents publicly disclose their voting records - 73.4 per cent in 2011 as compared to 69.0 per cent in 2010.

In conclusion, more UK institutional investors are committing to stewardship and are increasingly transparent about doing so.

In this context, asset managers are fiduciaries acting on behalf of their clients, they offer their clients a choice and take a range of approaches to managing money. Some believe that actively engaging with investee companies will achieve better returns. Others believe the best way to send a signal to a badly managed company and maximise returns for their clients is to sell their holding. Asset managers have a duty to act in the best interests of their clients at all times. If that interest is better served by decisions to buy and sell shares rather than seeking to persuade companies to change course, then it is not surprising that they should do so. A healthy market needs a variety of business models and approaches, and we would not support any prescriptive approach to the matter.

There are also limitations in what such oversight can achieve. Asset managers are restricted in terms of the information that is made available to them. They do not have insider status and are not privy to the same information as the executive or indeed the non-executive directors. It is not unreasonable for fund managers to take in good faith assurances and information from management. UK asset managers also typically have relatively small holdings, particularly in larger companies. However, given the lower propensity for non–UK shareholders to vote at general meetings, a manageable group of UK shareholders could together constitute a significant proportion of those voting on any poll. But, there are concerns that acting collectively with like-minded investors to bring pressure to bear on management could trigger issues of insider trading, changes of control and “the concert party” rules.

In conclusion, there are limitations in what engagement can achieve – asset managers do not run companies; they do not set strategy nor are they insiders, in that they only have access to information that is available to the market as a whole. Managers compensate for such information asymmetries by diversifying their portfolio construction. Nevertheless the main asset managers are committed to good governance and engagement as evidenced by the growing number of signatories to the Code. They recognise that not only does it help ensure that their investee companies are better run but should also help ensure a sustainable and stable financial system.

A mechanism for collective engagement

One of the recommendations in the report was that: "an investors' forum should be established to facilitate collective engagement by investors in UK companies". The report states that this is to facilitate supportive and critical action on issues of concern to investors, in general and in relation to particular companies.

The day the Government's published its response to the Review[23] we announced our intention to seek to facilitate the establishment of a mechanism that would respond to the objectives of the Review in this regard.

We are currently engaging with the investment community and completing a series of one-to-one meetings (including overseas, SWF and hedge fund investors) and some group discussions.

At the conclusion of this process, we will seek to determine, with other potential partners, whether it is possible to construct a mechanism that would secure sufficient support to add value to the collective forums that already exist.

[23] http://www.bis.gov.uk/assets/biscore/business-law/docs/e/12-1188-equity-markets-support-growth-response-to-kay-review

BIS: The Kay Review of UK Equity Markets and Long-Term Decision Making
Memorandum by the Investment Management Association

IMA position paper on fiduciary duty

Executive summary

- Discretionary investment management is an agency relationship governed by contract. Fiduciary duties for investment managers arise from their role as agents

- The contract sets out the detailed rights and responsibilities of the parties. Under the contract, the investment manager owes its client a duty to perform the contract with due care and skill (this is distinct from any fiduciary duty). The contract may modify and circumscribe fiduciary duties which may otherwise apply to the agent/principal relationship

- UK and EU regulators impose an additional level of protection by substantially codifying many areas that fiduciary duties are intended to address

- So while contract may modify fiduciary principles, there is a regulatory overlay such that fiduciary standards set in regulation are not capable of being contractually overridden

- Thus, the principal aspects of fiduciary duties for investment managers are governed by a combination of fiduciary principles at law, contract and regulation

Scope of paper

The paper describes the relationship between a discretionary investment manager and its institutional client, focusing exclusively on segregated mandates. We will be undertaking further work to analyse the position in relation to pooled vehicles.

It describes the agency nature of this relationship from which fiduciary duties arise, the contractual arrangements between the parties and what they are intended to achieve and the regulatory context to which investment managers are subject. The paper explores the relationship and hierarchy between these three aspects: fiduciary principles, contractual obligations and regulation.

A general overview of the asset management business and the various players in the investment chain are set out in the Appendix to this paper.

The paper sets out the position as a matter of English law and under relevant UK and EU regulation. It does not consider in any detail the legal obligations of an investment manager's direct clients to their own clients, for example where the manager's client is the trustee of a pension scheme.

I. Key relationships

Discretionary investment management relationship

A discretionary investment management relationship is a relationship pursuant to which a client engages an investment manager to provide the service of investing that client's assets on its behalf in accordance with certain investment guidelines that have been agreed between the client and the investment manager. Typically, the client gives to the investment manager full discretion to act for and on its behalf to invest a portion of its assets without needing to obtain the client's agreement to any specific transaction.

An example of a discretionary relationship would be Pension Fund X wishing to appoint an investment manager to manage a £100mn of its assets in global equities. As the result of a selection process that we outline in the Appendix, Investment Manager A would be given authority to invest this in line with the agreed terms (the "mandate").

(A discretionary investment management relationship is distinct from an advisory relationship where only advice is provided and the client makes the final investment decision.)

Agency relationship

A discretionary investment management relationship is by its nature an agency relationship with the client as principal and the investment manager as agent having typically been given authority by the client to invest the client's assets.

Contractual relationship

A discretionary investment management relationship is now invariably governed by a contract between the client and the investment manager. Thus the agency relationship between the investment manager and its client arises by express written contractual agreement. This contract is usually known as an "investment management agreement" and it contains, inter alia, an express appointment by the principal and an agreement by the agent to accept the position. As a matter of contract and agency law, the investment manager (as the client's agent) is under a duty to act within the scope of the authority given to it by its client.

Investment management agreements are comprehensive and lengthy documents which, in addition to the agency appointment, cover all matters arising in the relationship from commencement to termination and all matters in between. The investment management agreement will set out the rights, duties and responsibilities of the parties as well as the commercial substance of the contract namely the investment objectives of the mandate, how they will be achieved, any special requirements or restrictions and any appropriate benchmarks and performance standards.

The Investment Management Association has produced a model discretionary investment management agreement which is widely used in the industry. The current model agreement is 45 pages long. It is only a model agreement and is invariably tailored to the specific requirements of the parties. Some investment managers and some clients produce their own version of discretionary investment management agreements. These agreements are usually equally comprehensive and lengthy.

As a general observation, investment management agreements are frequently heavily negotiated between the parties. Clients are often professionally represented in these contract negotiations (whether by their lawyers or, where relevant, by their investment consultant (see Appendix for further details)).

II. The contractual position

The investment manager has a contractual obligation to provide the services as set out in the investment management agreement. These contractual duties are distinct from fiduciary duties.

The investment manager has a contractual obligation (whether express or implied) to perform its obligations with reasonable care and skill in accordance with the standard of care that could reasonably be expected of a professional discretionary investment manager. The duty of care and skill is distinct from a fiduciary duty.

The duty of care and skill does not exist in a vacuum. It is determined principally by the terms of the service the investment manager has been asked to provide. If a pension scheme client wanted to alter the scope of the mandate it gives to the investment manager, clearly it could do this, but the investment manager's contractual obligation is to follow the mandate given to it by the client. For the investment manager to follow a separate social or other policy that is not in the mandate could be a breach of duty and, if it were a breach, the investment manager would be acting outside the scope of its authority as agent.

If the manager or someone else benefited from such action, conceivably it might also amount to a conflict of interest where the investment manager was favouring someone else's interests at the expense of its client.

It would always be open to Parliament to create new duties by statute, for instance requiring an investment manager when acting for a pension scheme to take account of various matters outside the scope of its contractual mandate. But that would be the creation of a new statutory duty.

Another important aspect of the contractual relationship is that the investment manager has a direct contractual relationship with its client but it does not have a contractual relationship with its client's own underlying clients who are the investors or beneficiaries and may not have any information about them.

So taking the example of a UK trust based pension fund, the investment manager's client is the scheme trustee. The investment manager owes its contractual duties to the trustee and not to the scheme's beneficiaries. The pension scheme trustees have distinct duties and responsibilities towards the scheme beneficiaries.

III. Fiduciary principles in Equity

Fiduciary principles were developed in Equity (as opposed to common law) and as a result the evolution of the principles owed much to the situation-specificity and flexibility which are Equity's hallmark. The nature and the scope of fiduciary duties have been developed by the courts over time in cases which examine disparate fiduciary relationships. Further, this is not a static area of law; it will keep evolving. By its very nature and purpose, the concept needs to retain some elasticity[24]. It is recognised as a complex area of law.

As a matter of English law, certain relationships are considered "fiduciary" relationships giving rise to fiduciary duties. There is no exhaustive list of the categories of fiduciary relationships. The archetypical fiduciary relationship is the trustee-beneficiary relationship but other recognised fiduciary relationships include company directors/ companies, solicitor/client and principal/agent. The distinctive feature of agency is that the agent has power acting on behalf of its principal to change its principal's relationship with third parties.

In view of the inherent flexibility of the fiduciary duty doctrine in Equity, there is currently no single all-embracing general definition of what a fiduciary duty involves. Nevertheless, particularly in the context of an agent-based relationship, the nature of the fiduciary obligations are reasonably clear even though they may have been summarised in different ways and have been expressed differently at different times by the courts. For our purposes, in relation to an investment manager, to say that a firm is a fiduciary means that it has a special relationship of trust (though it is not a trustee) and confidence with its client and a corresponding duty of loyalty. The duties ascribed have been variously described as a "duty of loyalty", a "duty to avoid conflicts", a "duty not to make secret profit", a "duty to act in the best interest of the client", a "duty of good faith", a "duty of confidentiality", etc. The Law Commission's approach[25] in relation to fiduciaries generally (not just agents) was to summarise the fiduciary duty in four basic rules from which the various forms of fiduciary duty could be developed. The four basic rules are:

1. the "no conflict" rule;
2. the "no profit rule";
3. the undivided loyalty rule; and,
4. the duty of confidentiality.

IV. The role of contract and its relationship with fiduciary duties

It is crucial to understand that many of the fiduciary principles developed in case law stem from days where there were no detailed contracts. Equity was there to provide certain standards in cases where the contract did not do so or there was no contract. As Equity was effectively stepping in to do something for someone, the standards developed in case law were extremely high and the principles developed were broad brush in nature. Fiduciary duties as set out in the case law are therefore at the strictest end of the scale.

[24]"Equitable principles have above all a distinctive ethical quality. They are of their nature of great width and elasticity ...
[T]he establishment of fiduciary duties ... may arise in any circumstances at all, whether or not similar circumstances have come about previously..." Spry, Equitable Remedies (3rd Ed 1984)

[25]Law Commission of England and Wales Fiduciary Duties and Regulatory Rules (no 236 1995 December 1995), paragraph 1.4

The purpose of a contract between parties is to define the rights and duties arising between them. So for example, in the case of an agency relationship, where this is agreed, the result may be to modify and circumscribe the fiduciary duties which would otherwise apply to a principal/agent relationship.

The scope of fiduciary duties and the impact of express and implied terms on those duties are examined in the leading case in this area Kelly v Cooper (1993). This case is of particular importance. It confirmed that where a fiduciary relationship arises out of contract, a clearly worded duty defining or exclusion clause will circumscribe the extent of the fiduciary duties owed to the other party. The Law Commission commented as follows on Kelly v Cooper.

"We examined Kelly in detail in paragraphs 3.24-3.36 above, and concluded that it is now clear that the scope of the fiduciary duties owed by an agent to his principal is defined by the express and implied terms of the contract of agency, and that a clear and unambiguous duty defining or exclusion clause will delimit the scope of the fiduciary duties owed to the customer. However, in determining whether a relationship is fiduciary, and if so the extent of the fiduciary duties, its description in the contract will not be conclusive if it does not reflect the true substance of the relationship[26]

If the fiduciary duties were not modified or circumscribed using contractual techniques, the strict principles arising in equity might apply. This may not represent the intention of the parties as to how they wish their relationship to operate and in certain cases a party would not, in practice, be able to comply with the principles which would otherwise apply. It is therefore usual for a contract to define the duty an agent owes to its principal in some detail, with the result that the scope of the fiduciary duties owed are defined by the contract.

V. Fiduciary duties and conflicts of interest in the investment management context

In the financial services arena, a firm acting "for and on behalf of its client" is likely to be acting in a fiduciary capacity. Specifically, the agent-based fiduciary is typified by the discretionary investment manager exercising discretion over the client's assets it manages.

In the context of the relationship between a discretionary investment manager and its client, various potential conflicts of duties and interest may arise. For example, firm/client conflicts may arise in the area of fees and other benefits often involving third parties - covered in regulation by the concept of "inducements" e.g. a firm pays a commission or fee to a third party which is deducted from the investment the client makes through the firm, or a commission is earned by the firm in connection with its mandate from persons other than the client. Client/client conflicts may, for example, manifest themselves in areas such as aggregation and allocation of a block trade across different client accounts and arranging transactions between clients (agency cross trades).

[26] Law Commission of England and Wales Fiduciary Duties and Regulatory Rule s (no 236 December 1995), paragraph 7.3

Investment managers deal with these potential conflicts by setting out the duties and responsibilities of the parties (i.e. the investment manager's direct client and the investment manager) in a detailed investment management agreement. The agreement will define the scope of the fiduciary duties owed and what the investment manager can and cannot do. However, the position on conflicts including conflicts management in the financial services area has been substantially codified by regulation. An investment manager, as a regulated investment firm (see Appendix for further details), is required to adhere to that regulation and the contract cannot override any regulatory requirements.

VI. The financial services regulation

Financial services regulation introduces protections in many of the areas that fiduciary duties are intended to address through various conduct of business rules and in particular the conflicts of interest rules. The starting point is the concept of a conflict, not the concept of a fiduciary, although the existence of a conflict presupposes the existence of a fiduciary relationship (in the UK in any event).

The relevant EU legislation for asset managers is the Markets in Financial Instruments Directive (MiFID) and its implementing legislation. MiFID Level 1 Article 19 sets out the general principle for an investment firm to "act honestly, fairly and professionally in accordance with the best interests of its clients..." There are further detailed provisions at Level 2 (Art 26 ff). In the UK, FSA Principle 6 on "Customer's interests" provides that:

"A firm must pay due regard to the interests of its customers and treat them fairly" and this is also reflected in chapter 2 of the FSA's Conduct of Business Sourcebook.

The main EU rules on conflicts are contained in MIFID L1: Art 13(3) and 18; Level 2 Art 21-23. In the UK, FSA Principle 8 on "Conflicts of interest" provides that "A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client". The MiFID conflicts rules are implemented in the UK in SYSC 10 of the FSA Handbook.

The MiFID conflict rules which apply to all discretionary investment managers now require that conflicts are managed as far as practicable and that only those which cannot be managed are then put to the client so that consent to their existence can be sought.

In some cases, regulation deals with certain conflicts by prescribing a particular way of dealing with them. Examples include the best execution rule, rules on aggregation and allocation of trades, rules on inducements and rules on commission sharing.

The regulatory treatment of conflicts is detailed and comprehensive. This section only provides a high level overview.

VII. The relationship between fiduciary principles, contract and regulation

The contract will define what the rights and obligations are between the parties - and so may affect the fiduciary duties. It would be possible for a fiduciary duty to co-exist with a contract depending on what the contract said. However, if the parties had agreed to something e.g. how to deal with conflicts, that agreement could change the fiduciary duty that would otherwise apply.

A regulatory requirement takes precedence over a contractual provision in the sense that a regulated person must follow it and can be sanctioned and fined by the FSA if it does not (regardless of what the contract says).

Regulatory rules relating to the areas of fiduciary duty may co-exist with fiduciary principles at common law and in equity. The regulators may have refined, restated or modified requirements of a fiduciary duty in a given context in the light of the totality of the safeguards under the regulatory scheme. Regulatory rules may potentially conflict with common law and equitable rules thus giving rise to uncertainty. The Law Commission considered this issue and concluded as follows:

"We said in the consultation paper that we believed that a court, faced with a mismatch between fiduciary duties and what is required or permitted by regulatory rules, would probably take account of regulatory rules in determining the content of the fiduciary duty. Although there have been no cases since then directly on this point, we believe that the approach of the courts in cases such as Kelly and Target Holdings would tend to support this conclusion. We also accept that contractual techniques can go a long way towards dealing with most problems of mismatch which are likely to occur. We do not consider that, in general, the remaining difficulties and uncertainties are such that we should pursue the provisional recommendation 9 that there should be legislation to the effect that fiduciary duties should take account of regulatory rules in the light of the limited support it received on consultation[27]".

We are of the view that while it would be open to the courts to apply a separate common law approach to financial services firms' conflicts, the regulators' conflicts rules are likely to be a significant factor in any court decision (provided there was authority to make the rule and subject to a reasonable regulation test). The likelihood is that the two regimes will gradually harmonise with the regulatory regime increasingly being treated as setting the market standard of behaviour and taking the lead in future developments.

VIII. Conclusion

The agency model that defines discretionary investment management services gives rise to fiduciary duties for investment managers.

While fiduciary principles at law may not be capable of exact definition and need to retain that inherent quality of flexibility which characterises the law in this area, the principles have been articulated in a reasonably clear manner as regards the principal/agent relationship which is how fiduciary duties arise in a discretionary investment management relationship.

[27] Law Commission of England and Wales Fiduciary Duties and Regulatory Rules (no 236 December 1995), paragraph 14.20

IMA position paper on fiduciary duty

The contract spells out in detail the rights, duties and obligations of the parties. Independently of any fiduciary duties arising, investment managers have a separate and distinct duty of care and skill towards their clients. The contract may modify and circumscribe fiduciary duties which would otherwise apply in the principal/agent relationship. The primacy of contract has been affirmed in a landmark case in this area.

However, in the financial services context, many areas that fiduciary duties are intended to address have been codified in regulation at UK and European level. There is, as a result, a regulatory overlay which contract cannot override.

Therefore, fiduciary duties as they arise in a discretionary investment management relationship are governed by a combination of fiduciary principles at law, contract and regulation.

IMA, November 2012