



The Economic Role of Finance:

A Contribution to the The Kay Review of UK Equity Markets and Long-Term Decision Making

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Introduction

This contribution is written by a number of participants and directors of the Network for Sustainable Financial Markets (NSFM), an international, non-partisan, non-profit organization comprised of financial market professionals and academics.¹ We strongly welcome the Kay Review, in which the mechanisms of corporate control and accountability provided by UK equity markets are examined for their effect on the long term competitive performance of UK businesses. We believe it could have a significant positive impact in the UK but also important knock-on international effects, especially with regard to countries following the Anglo-Saxon model.

In light of the financial crisis and continuing instabilities in developed market economies, we expect normative debates about how to create healthy economies to become more prominent. The perspective we bring is a sample of perspectives from NSFM. Acting outside of organisational affiliations and thus with reduced agency interests, we believe informed practitioners and commentators are well suited to identify current systemic problems and help to develop communities of practice within financial institutions to address those problems. It is in that spirit that we provide the following views, culled from the work and insights of many of our colleagues in NSFM.²

In this paper we respond to the commission's request for two kinds of evidence:

1. Academic studies of, e.g., problems in operating companies making long-term decisions because of capital market pressures; problems in the pension fund supply chain; investment time horizons for asset managers leading to strategies for pension fund management that put excessive emphasis on short term results, and so forth.
2. Personal experiences of market professionals observing short-term pressures, sought from all points on the investment supply chain.

We will discuss three issues created by an excessive focus on short-term results in capital market activities.

- (1) Capital markets may fail to allocate capital intelligently, with particularly problematic implications for newer projects, riskier projects, or projects with long-term value. In a

¹ See <http://www.sustainablefinancialmarkets.net> for further details about NSFM's goals and participants.

² This contribution to the Kay Commission's work is derived from both academic papers by the authors and contributions to other consultations that NSFM participants have submitted. As a wiki community, NSFM does not take policy positions itself but invites its participants to indicate support on a project by project basis.

healthy market composed of investors with heterogeneous risk appetites, time frames for investment, and processes of quantitative analysis this should not, in theory, be a problem. Yet, if the balance of investors in a capital market is shifted too sharply in favour of investors chasing short-term results, using very similar quantitative models, technologies, and funding mechanisms, this is likely to become a problem for effective capital allocation: short-term money will tend to drive out long-term money.

- (2) Companies may be under pressure to prioritize short-term results to meet the quarterly expectations of capital market analysts, at the expense of longer-term projects.
- (3) Pension fund beneficiaries who have interests in the long-term success of their pension fund(s) for the provision of retirement income 25 – 50 years into the future could find growth of their capital undermined by actions by asset managers that increase the expenses of the fund to the detriment of the beneficiaries, or by actions of the asset managers that are otherwise inconsistent with most beneficiaries' long-term interests.

We will then conclude with some suggestions about how to strengthen the productive role of finance in the U.K., taking into account the concerns discussed in this paper.

I. Capital markets as efficient allocators of capital

In general, the financial sector has an economic function, which is to provide capital to companies, consumers and society for both short-term and long-term projects. This assertion is so simple it seems absolutely obvious, and yet there is cause to be concerned that finance is not adequately serving this social function in its current state. A corollary of this view is that finance cannot be a world on its own—or, more precisely, to the extent that finance becomes predominantly occupied with transactions within finance and not investments in “real economy” value creation, it undermines its important social function. Much as marketing or HR within companies cannot be a world on their own, so too finance cannot productively operate divorced from its social function. The ‘serving function’ of finance should be the cornerstone of regulation and governmental policies. Currently, however, fundamentalist market theory is still influential in shaping regulatory regimes, with the result that the social function of finance is not prioritized.

A. Fallacies in fundamentalist market theory

The last thirty years have been dominated, in theory and practice, by a complex of beliefs about the operation of the capital markets and global financial integration that Nobel-laureate and former World Bank Chief Economist Joseph Stiglitz has called ‘market fundamentalism’.³ The macroeconomic version of the theory is that global ‘capital-market liberalization should be good for economic growth and [reducing] the volatility of consumption’ of developing economies.⁴ In contrast to the theoretical predictions, by 2003 even the IMF Board recognised that ‘it becomes difficult to make a convincing connection between financial integration and economic growth once other factors, such as trade flows and political stability are taken into account’.⁵ Actual capital market liberalisation and global integration have thus been associated with greater financial instability, more frequent currency crises, real economic dislocation and pro-cyclical flows of ‘hot

³ Joseph Stiglitz, ‘Capital-Market Liberalization, Globalization, and the IMF’ (2004) 20 *Oxford Review of Economic Policy* 57, 57.

⁴ Ibid 59.

⁵ Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M Ayhan Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence* (2003) International Monetary Fund <<http://www.imf.org/external/np/res/docs/2003/031703.pdf>> at 12 September 2009.

money' that do not necessarily lead to long-term growth.⁶ In part this disconnect between neoclassical economic theory and real world results is because the underlying assumptions of the neoclassical model, assuming 'perfect information, perfect capital markets, and perfect competition' are 'a poor description of developed economies, and an even poorer description of developing countries and international capital markets'.⁷

Notwithstanding their weak descriptive validity, regulators in the developed economies of the United States and the United Kingdom have relied upon similar fundamentalist assumptions of neoclassical theory⁸ in promoting capital market deregulation within domestic economies. These underlying assumptions for capital market regulation include:

- 1) Market prices of capital assets efficiently incorporate all available public information ('the efficient capital markets hypothesis') and reflect rational judgments about the discounted present value of future income streams from those assets ('the capital asset pricing model').
- 2) So long as markets are transparent and do not suffer from information asymmetries then,
 - a. Self-interested investors will make rational economic decisions to maximize their own utility consistent with their preferences for risk, return and liquidity,
 - b. Which will lead to capital being allocated efficiently amongst a range of all possible productive uses of that capital; and
 - c. As a result, social utility will be advanced, as the 'best' uses of productive intellectual and financial capital will prevail in the market.

Given such assumptions, governments have a number of important roles in capital market regulation. First, governments must establish the background conditions that are necessary for deep, liquid capital markets to thrive. These background conditions include well-developed rule of law norms; the potential for contracts to be enforced and property rights to be respected; sufficient securities law development and enforcement to protect against fraud. Second, governments have a role to play in addressing information asymmetries and other information imperfections so that investors can have access to accurate and comparable information. Securities disclosure regimes are thus important, including for the establishment of accurate accounting standards. Beyond these roles, however, fundamentalist market theories see a quite limited role for government, particularly as regards (a) fostering the intelligent allocation of capital; (b) addressing the dynamics of economic inequalities; or (c) balancing the political power of market actors with the rest of society.

Of course, criticisms of market fundamentalism have reached and been taken forward by mainstream economists. Much economic research today is focused on further describing, detailing

⁶ See Dani Rodrik, *Has Globalization Gone Too Far* (1997); Francisco Rodriguez and Dani Rodrik, 'Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence' (2000) 15 *NBER Macroeconomics Annual* 261.

⁷ Stiglitz, above n 3, 59.

⁸ For an overview and critique of neo-classical thinking, see Lord Adair Turner, *The Turner Review: A regulatory Response to the Global Banking Crisis* (2009) Financial Service Authority, available at http://www.fsa.gov.uk/pubs/other/turner_reviw.pdf, chapter one; see also De Graaf, F.J., Williams, C. (2009), *The intellectual foundations of the global financial crisis: Analysis and proposals for global reform*, UNSW Law Journal. 32(2), pp. 390-415, available at <http://www.ssrn.com/abstract=1523831> (summarizing various academic criticisms).

and specifying the assumptions of the neoclassical model and making clear when they work and when they do not.⁹ Behavioural finance can be seen as an example here. It has established the existence of common biases and heuristics in the way people process information; understanding these biases has informed and led to the modification of key rationality assumptions.¹⁰ Information imperfections are now well understood to undermine the smooth functioning of real markets and to create credit and equity rationing.¹¹ Critical commentary has also shown that empirical results in real world financial markets and real world economies defied economic predictions. Herding, asset bubbles, ‘irrational exuberance’ and momentum effects, just to name a few have undermined theories of fundamental value efficiency.¹² Even the self-interest assumption was subject to empirical examination, and found to need significant qualification. Thus, people generally exhibit fairness constraints on their self-interested behaviour in laboratory experiments (less so economics students), in their relationships and even within firms, depending on the justice climate of the firm.

And yet an alliance of ‘ideology and [economic] interests’¹³ convinced regulators and policy makers to continue promoting capital market deregulation based on simple neoclassical models, particularly in the last decade, and particularly in the United States. One result – before the global financial and economic crisis – has been the rapid expansion of the financial sector within the United States and the United Kingdom.¹⁴ By 2006, approximately 40 per cent of corporate profits in the United States and United Kingdom were based on finance – producing ‘activities internal to the banking system [that were] growing far more rapidly than end services to the real economy’.¹⁵ (These profits have been shown to be ephemeral, as \$7.2 trillion of public funds through 2009 have been committed to shore up decimated bank balance sheets in the United States alone.¹⁶) Another result is that American investors, hungry for profits and with enormous pools of assets (pension funds, hedge funds and private equity) to invest increasingly (a) justified their search for yield by claiming that private, shareholder wealth-maximising behaviour by firms and finance was the path to social wealth-maximising and (b) increased the pressure on European firms and countries to adopt clearer allegiances to shareholders and to abandon ‘old European’ versions of stakeholder capitalism.¹⁷

B. Implications of fundamentalist market thinking

If these market developments corresponded with an era characterized by the effective allocation of capital to small businesses, to new projects, to innovative and flourishing societies, and

⁹ See generally Joseph Stiglitz, *Freefall: America, Free Markets, and the Sinking of the World Economy* 243-261 (2010).

¹⁰ See Daniel Kahneman, Paul Slovic and Amos Tversky (eds), *Judgment Under Uncertainty: Heuristics and Biases* (1982).

¹¹ Stiglitz, above n 3, 59; Stiglitz, above n. 9.

¹² Robert Shiller’s book *Irrational Exuberance* (2000) is the provenance for the quoted term. See Stiglitz above n. 3 and Turner, above n 2 for discussion of herding, asset bubbles, momentum effects, home country biases, credit rationing and other real-world conditions inconsistent with neoclassical economic theory.

¹³ Stiglitz, above n 3.

¹⁴ See Turner, above n 2, 16.

¹⁵ Ibid.

¹⁶ Judge Richard Allen Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (2009) xi. The \$7.2 trillion figure includes \$5.2 trillion by the Federal Reserve in various standby arrangements and acceptance of unmarketable securities as collateral for prime rate loans; and \$2 trillion by the Treasury Department.

¹⁷ Marie-Laure Djelic and Jabril Bensedrine, ‘Globalization and Its Limits: The Making of International Regulation’ in Glenn Morgan, Peer Hull Kristensen and Richard Whitley (eds), *The Multinational Firm: Organizing across Institutional and National Divides* (2001), 253.

to the long-term health of the underlying economies in the U.S. and the U.K., there would be little cause for concern. That has demonstrably, and unfortunately, not been the case. The following data are illustrative here:

Table 1: Change in bank market capitalization

	Change 1999-2009 (\$bn)
Australia	+85.6
Canada	+97.5
UK	-211.4
USA	-633.0

Source: Peter Thal Larsen & Simon Briscoe, ‘The Fearsome Become the Fallen,’ *Financial Times*, 22 March 2009, p.9. *Chart reprinted from Sue Konzelmann, Marc Fovargue-Davies and Gerhard Schnyder, The Faces of Liberal Capitalism: Anglo-Saxon Banking Systems in Crisis*, Cambridge Journal of Economics, *forthcoming* and Centre for Business Research, University of Cambridge, Working Paper No. 403, available at <http://www.cbr.cam.ac.uk/pdf/WP403.pdf>. 1999 values are as of 31 May 1999; 2009 values are as of 17 March 2009.

As Konzelmann et al. point out, “By March 2009, American rescue packages amounted to 6.8 percent of GDP and the UK’s a staggering 19.8 percent”, indicating that some degree of the prior decade’s apparent success was built on a socially-risky foundation. Moreover, real annual growth from 2000 through 2008, at least in the United States, was lower than in any other decade since the mid-1930s.¹⁸

As Keynes recognized early on, there is no *a priori* reason to think that the private pursuit of wealth is going to lead to increased social welfare. Presumably in the prior two decades there could have been effective allocation of capital at the micro level being undermined by macro trends and policies in both the US and UK. Moreover it is clear that macroeconomic imbalances had a significant role to play in the dismal results of the deregulation era,¹⁹ and that there were many innovations in technology, particularly computer technology, that were more-than-adequately funded. Yet, the evident failings of fundamentalist market thinking to be translated into healthy social outcomes at least shifts the burden of proof to defenders of the extreme versions of neoliberal capitalism to show why a new approach is not in order

¹⁸ Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* 147 (2010, 2011), *citing* Bureau of Economic Analysis, *National Income and Product Accounts*, Table 1.1.6, *available at* <http://www.bea.gov/national/nipaweb/Index.asp>.

¹⁹ See Charles Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (New York: Basic Books 1978) (asserting that from 1945 to 1971 there were no financial crises anywhere in the world, with the exception of Brazil in 1962, in contrast to the prior 400 years when a financial crisis occurred about once every 10 years; and further asserting that the reason for that global stability in 1945-1971 was more and better regulation).

C. Importance of understanding government's role

This critique may seem beyond the remit of the Kay Review, but we submit that it isn't. There must be a theory for why short term thinking is a problem in order to inform policy analysis. The theory being propounded here is that (a) government must have a greater role in shaping capital markets, particularly to incent balance in allocation of capital between short-term and long-term (but potentially socially valuable) real-economy innovation (using tax credits, insurance, first loss provisions, etc.); and that (b) improperly regulated financial markets will not intelligently allocate capital to advance these social goals, but will magnify the cyclicity and instability we've seen by virtue of chasing short-term returns from financial innovation and purely financial transactions, neither advancing innovation beyond the financial sector nor promoting healthy societies. So, in effect, what we are arguing is that *a theory of the role of government in the markets is necessary* to address the problem of "short-termism."

II. **Aligning the long-term interests of investors and companies**

Even without a theory of the proper role for government intervention in the markets, one might look to long-term investors such as pension funds to provide the necessary patient capital to counter-balance the automated trading programs, millisecond traders, sophisticated arbitrageurs, momentum investors, and other short-term financial specialists whose trading approaches are largely divorced from company value and which have proliferated in many modern markets. Ibbotson reports in the March/April 2010 Financial Analysts Journal that "[i]n general (after controlling for interaction effects), about three-quarters of a typical fund's variation in time-series returns comes from general market movement."²⁰ This result provides an argument for greater emphasis on stewardship and investor engagement (on a company and market level), since most return and risk is associated with beta exposure. Gone are the days when institutional investors were bit players in the markets. They now move markets and determine corporate behaviour by what actions and information they demand or ignore.

Given institutional investors' long-term liabilities and exposure to broad market returns for most of their earnings,²¹ we expect that well-managed funds will generally be concerned with the long-term profitability of the companies and economies in which they invest. That is not to say that short-term investment is inherently bad. The point is that better balance of investment time horizons is needed to match the long-term investment goals of most underlying beneficial owners. Addressing the behavioural biases and economic incentives that drive this mismatch is squarely within government's remit.

Institutional investors with long-term obligations should thus provide the patient capital needed to support healthy, growing, innovative economies. Indeed, there is evidence that many of the leading public pension funds, endowments and sovereign wealth funds understand that long-term challenges affect the economic well-being of their beneficiaries, and are taking steps to analyse and address those challenges. Among many collective initiatives by the industry in this respect are the Principles for Responsible Investment (PRI), which provide mechanisms for the incorporation of environmental, social and governance information into investment and ownership decisions.²² Such

²⁰ See Roger Ibbotson, *The Importance of Asset Allocation*, Financial Analysts Journal (March/April 2010) (estimating that about 75% of a typical fund's returns come from general exposure to the market (beta), not from alpha seeking strategies).

²¹ *Id.*

²² See <http://www.unpri.org>.

information is likely to be particularly salient for identifying long-term risks to investors' portfolios, and, in theory, lead to more socially productive allocation of capital. To date over 850 institutional investors, comprising \$22 trillion of invested capital, have made commitments to apply the PRI in their investment approach.²³

Notwithstanding that such initiatives amongst institutional investors recognise the importance of a long-term perspective, members of the NSFM's fiduciary working group agree that there is a problem with excessive short-term pressures on operating companies originating in capital markets. US academic research has found that pressure on corporate managers to deliver short-term investment results has become so strong that nearly 80% of chief financial officers report they would sacrifice future economic value to manage short-term earnings so as to meet investor expectations.²⁴ Some of the actions that these managers say they would take to meet analysts' expectations include delaying long-term investments, reducing research and development expenditures, or eliminating planned marketing campaigns. This research result, even though based on survey self-reporting, suggests that further investigation of the issue is warranted—as the British Government has recognized with this review.

III. Misaligned incentives between pension funds and their asset managers

Given that institutional investors with long-term liabilities, such as pension funds, endowments and foundations should presumably strive for long-term results (with flexibility to meet their obligations to current obligations), and given the size of this pool of could-be-patient-capital,²⁵ the challenge is to identify why, despite this, short-term, quarter-by-quarter pressures predominate in the capital markets. The constraints that discourage long-term investors from adopting a more balanced approach include their liability profile, investment beliefs, risk appetite and decision-making structure.²⁶ It is worth noting that these roadblocks are primarily behavioral and governance issues. Facilitating the creation of incentives to develop and implement solutions could fall squarely within the government's remit.

A. Narrow understanding of fiduciary responsibility

We submit that one of the most significant underlying factors is a narrow and inaccurate understanding of the fiduciary responsibility of investor representatives²⁷. This understanding has actually encouraged lemming-like behaviour because of the typical focus on peer group comparison and short-term results. The phenomenon was examined by the investment industry's leading global authority on investor protection and financial market ethics, the CFA Institute Centre for Financial Market Integrity, and the Business Roundtable Institute for Corporate Ethics, which represents CEOs from 160 global companies. After engaging thought leaders from the corporate issuer, investment analyst, asset manager, institutional investor and individual investor communities, the study group concluded:

²³ See http://www.unpri.org/files/2010_Report-on-progress-press-release.pdf.

²⁴ John Graham, Campbell Harvey and Shivaram Rajgopal, "Value Destruction and Financial Reporting Decisions," 62 *Financial Analysts' Journal* 27, 27-29 (2006), also available at SSRN: <http://ssrn.com/abstract=871215>.

²⁵ See World Economic Forum, *The Future of Long-Term Investing* (2011), available at http://www3.weforum.org/docs/WEF_FutureLongTermInvesting_Report2011.pdf p. 9 and Appendix A (collecting data showing that \$ 27 trillion of approximately \$ 65 trillion of assets under professional management is held by long-term investors such as pension funds, life insurers, sovereign wealth funds, foundations, and endowments).

²⁶*Id.*, at 17.

²⁷ See Keith L. Johnson and Frank Jan de Graaf, "Modernizing Pension Fund Legal Standards for the Twenty-First Century," *Rotman International Journal of Pension Management*, Vol. 2, No. 1 (2009).

“The obsession with short-term results by investors, asset management firms, and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance.”²⁸ [Emphasis added.]

That a concern with short-term results leads to value destruction has been substantiated by academic research. While most mandates to asset managers are for a period of one to three years, performance is generally monitored on a quarterly basis against a peer/relative returns benchmark. If a manager has underperformed over several quarters towards the end of a mandate, its client might move assets to an asset manager that has outperformed the benchmark over the same time period. Thus, clients engage asset managers at the top of their performance and fire them at the bottom: money is lost, often on a significant scale. A recently published study confirmed prior findings that institutional investors lost value by changing manager allocations based on a number of quarters of results:

“By looking at the percentage difference in performance of those managers with the highest flows, and those with the lowest flows (by quintile), it concluded managers receiving contributions underperform those which experience withdrawals. Further this underperformance persists over one, three and five years, and can be up to 300 basis points.”²⁹

Other research has found a number of economically and socially negative outcomes to be associated with excessive short-term investment. For example, companies with higher percentages of short-term owners do more value-destroying mergers and acquisitions and, as targets, are likely to receive acquisitions bids but get lower premiums; short-term investment behaviours have been on the rise in both the UK and US, with future investment cash flows five or more years ahead being excessively and irrationally discounted; companies with investors identified as having a short-term outlook are more often associated with downsizing of research and development budgets.³⁰

Moreover, the turnover (churning) of shares in institutional investors’ portfolios is often substantial, which brings heightened transaction costs, and often exceeds expected turnover ranges. A 2010 study by Mercer and the IRRIC Institute found that 65 percent of investment strategies produce higher portfolio turnover and have shorter investment horizons than intended.³¹ In banking specifically, Andrew Haldane’s research at the Bank of England shows that the average time institutional investors own bank shares in the US and UK has gone from three years in 1998 to three months in 2008.³² This may be a rational strategy for these investors, since Mr. Haldane’s research further concludes that long-term investors are not benefiting from incentive distortions in banking derived from the “eye-popping” implicit government subsidies from too-big-to-fail banks; rather

²⁸ “*Breaking the Short-Term Cycle*,” the CFA Centre for financial Market Integrity and Business Roundtable Institute for Corporate Ethics (July 2006), available at <http://www.cfapubs.org/toc/ccb/2006/2006/1>.

²⁹ Amanda White, *Investor Behaviour Erodes Performance*, Top 1000 Funds.com, discussing Scott Stewart et al., *Absence of Value*” *An analysis of investment allocation decisions by institutional plan sponsors*, Financial Analysts’ Journal (2009). These research results were consistent with prior findings over more than a decade, as summarized in Watson Wyatt, *Hiring and Firing Managers*, April 2006.

³⁰ See Ben W. Heineman, Jr. and Stephen Davis, “*Are Institutional Investors Part of the Problem or Part of the Solution?*” 17 – 18 (2011), http://millstein.som.yale.edu/sites/millstein.som.yale.edu/files/80235_CED_WEB.pdf for a discussion of these studies.

³¹ See “*Investment Horizons- Do Managers Do What They Say?*” at <http://www.irricinstitute.org/projects.php?project=42>.

³² See Andrew Haldane, *Title* p. 12 and Chart 8 (Oct. 24, 2011), available at <http://www.bankofengland.co.uk/publications/speeches/2011/speech525.pdf>.

short-term investors and management are extracting the benefits.³³ Yet the result of these incentive distortions is pernicious from a social welfare perspective, as the financial and economic crises have demonstrated. Given the data discussed above on the importance to investors of market trends (beta), rational investors might conclude that the “out-performance” of banking stocks in their portfolios during some past periods is outweighed by losses in their portfolios from the downturn of the market as a whole, especially when transaction fees are taken into account.

Indeed, one of the authors has been in the pension industry for three decades and personally witnessed the shift in behaviour identified by the research. Three decades ago the focus of investment strategy discussions and performance reviews was on time horizons of three-, five- and ten-years. Fiduciaries now spend very little (if any) time on strategy and performance issues beyond monthly, quarterly and annual time frames. This change in focus and behaviour within the investment industry has been astounding - with no apparent advantage to beneficial owners.

These practices also raise questions about whether fiduciaries are adequately addressing their separate legal obligation to balance the interests of current and future pension fund beneficiaries impartially.³⁴ Excessive focus on short-term investment horizons, use of short-term benchmarks, and evaluation of portfolio managers primarily on short-term results, as well as inattention to risks associated with the potential long-term value destruction referenced above, should ring alarm bells for pension funds that are managing assets to meet liabilities extending out over generations. Short-termism has resulted in massive inter-generational transfers of risk and wealth – precisely what the duty of impartiality was designed to address.³⁵ The *fiduciary duty of impartiality*, which has been given little attention, needs to be dusted off and re-examined.³⁶ Again, this is squarely within the governmental remit under a ‘fit for purpose’ approach to regulation.

B. Failure to incorporate systemic and extra-financial factors

One result of adopting a more balanced investment approach that considers long-term risks and future wealth generation would be an expansion of the risks and opportunities that are seen as

³³ *Id.* at p. 11.

³⁴ The duty of impartiality is summarized in official comments to §79(1) of the Restatement of Trusts, Third, as follows: "In what might be called the 'substantive' aspects of impartiality . . . Subsection (1) directs trustees . . . to make diligent and good-faith efforts to identify, respect, and balance the various beneficial interests when carrying out the trustees' fiduciary responsibilities in managing, protecting, and distributing the trust estate, and in other administrative functions." In its Trustee Toolkit, the UK Pensions Regulator also describes the duty of impartiality. "*As a trustee, you must consider the interests of all the classes of beneficiary covered by the trust deed and rules and act impartially.*"

³⁵ See James P. Hawley, Keith L. Johnson and Ed Waitzer, "Reclaiming Fiduciary Duty Balance," *Rotman International Journal of Pension Management*, Vol. 4, Issue 2 (Fall 2011).

³⁶ The *Code of Conduct for Members of a Pension Scheme Governing Body* which was published by the CFA Institute Centre for Financial Market Integrity in 2008 also recognizes that an effective trustee will "consider the different types of beneficiaries relevant to each pension scheme" and "engage in a delicate balancing act of taking sufficient risk to generate long-term returns high enough to support real benefit increases for active participants who will become future beneficiaries while avoiding a level of risk that jeopardizes the safety of the payments to existing pensioners." In addition, in *Withers v. Teachers' Retirement System*, 447 F. Supp. 1248 (SDNY 1978), when the Court approved a New York City public pension fund investment in New York City bonds that were being issued to avoid the City's impending bankruptcy, it noted: "New York law imposes an obligation on trustees to accord impartial treatment to beneficiaries. It is more than evident, therefore, that the trustees of the TRS would have violated their fiduciary obligation had they exhausted the assets of an under funded actuarially reserved pension system on a single class of beneficiaries (retirees). Their obligation, plainly, was to manage the fund so as to enable it to meet its obligations not only to current retirees, but also to those scheduled to retire in the future, whose pension and annuity rights would have been similarly earned over their years of active service and to whom the fund therefore had a legal responsibility."

relevant to a fund's investment strategy. The CFA Institute advises that pension fund governing boards, in addition to considering "typical financial measures," must consider "all relevant risk and value factors," which "may include environmental, social, and corporate governance (ESG) issues."³⁷ New research by professors at the Harvard Business School and the London School of Business demonstrates that companies with a strategic focus on ESG issues, which they call 'high sustainability' companies, show financial outperformance, and a stock-market and accounting value premium after three years.³⁸ Their research further shows that the premiums continue to rise in further years. The findings of their research support the view that there is tangible, financial value to institutional investors that integrate environmental, social and governance (ESG) factors into their stock selection.

Given the recent impact of corporate governance, systemic and intangible factors (e.g., risk management failure, automobile industry product obsolescence, regulatory agency inaction, loss of investor trust in market fairness) on pension funds in the economic crisis, there should be no doubt about the potential importance of extra-financial issues to long-term investors with broad market exposure.³⁹ Unfortunately, most regulatory guidance on fiduciary and investment issues has taken a narrow view limited to quantitative measures. One by-product of the market crisis has been the realisation that there are many investment risks that lie outside of what was traditionally quantified by mainstream investment consultants, advisors and portfolio managers. This realization has been reinforced by events with companies as diverse as BP, Tepco and News Corporation. Systemic risks, which have been largely ignored, proved to be of great consequence. Now these risks need to be recognized, evaluated and addressed as a fiduciary concern.

With most markets having eliminated statutory legal lists of allowed (or precluded) pension fund investments (a development which we heartily endorse), the task of determining appropriate investment risk exposures now falls completely on pension fund fiduciaries.⁴⁰ Their collective effectiveness in fulfilling these duties will not only determine the future well-being of pension fund participants but will also play a major role in allocating capital between companies and in the health of the economy. Thus, the importance of investor governance and investment practices in this regard cannot be overstated. There is a sensitive interaction between pension fund regulation and corporate governance legislation. We provide some ideas below that could assist in the development of standards appropriate to the economic role of today's investors in interaction with investee companies.

C. Agency issues and conflicts of interest throughout the institutional investment value chain

The translation into heterogeneous investment behaviour of institutional investors' long-term exposure to the risks of entire markets (rather than into herding, momentum investing, excessive churning of shares, and such),⁴¹ is also hampered by multiple agency problems within the investment supply chain. Asset owners and companies, at opposing ends of the investment chain, are in many

³⁷ *Id.*

³⁸ See Robert G. Eccles, Ioannis Ioannou, and George Serafeim, (2011) *The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance*, HBR Working Paper 12-35, November 04, 2011.

³⁹ Some regulators might need to revisit past interpretations of fiduciary duty in order to explicitly recognize risks that did not exist when fiduciary laws were originally written and pension funds had little collective influence on the markets or the broader economy.

⁴⁰ In Dutch law, the only investment restriction which still exists is a limit on investments in the company related to the fund (Art 135). In Britain, Lord Mackenzie of Luton, Parliamentary Under Secretary of State for the House of Lords, representing the Department of Work & Pensions, summarized the Government's views on responsible investing by pension funds in October of 2010, "There is no reason why trustees cannot consider moral and social criteria, in addition to their usual criteria of financial returns, security and diversification."

⁴¹ For an excellent analysis of these phenomenon and their causes see Alfred Rappaport, *The Economics of Short-Term Performance Obsession*, 61 *Financial Analysts Journal* 65-79 (2005).

instances unable to align their long-term interests because the investment chain is fragmented. Table 1 provides an overview of the problem. Exercise of an appropriate theory about the role of government in the markets could facilitate changes to bring asset owners and companies closer together.

Table 2. Main stakeholders in the institutional investor service provider supply chain

Stakeholder	Horizon (Average)	Agency problem	General description
Participants & Beneficiaries	30+ years	Often have/exercise little control over either their contributions or investments.	Are neither involved or knowledgeable, which leads to mistrust in times of financial instability.
Managers of companies	3 to 5 years	Only know a few vocal or active investors. In many countries less than 30 percent vote proxies. Little interaction.	Feel hunted and pressured to deliver quarterly returns by investors they do not know; are influenced by incentives based on stock price.
Investment Managers	1 year	Work for clients who provide mandates for 1 to 3 year performance, but who rarely tolerate consecutive quarters of relative underperformance	Are incentivized by fees set on assets under management and evaluated relative to market benchmarks, which might not reflect pension funding needs.

Based on Keith L. Johnson and Frank Jan de Graaf, "Modernizing Pension Fund Legal Standards for the Twenty-First Century," Rotman International Journal of Pension Management, Vol. 2, No. 1 (2009).

Given the prevalence of misaligned interests throughout the investment chain, the importance of identifying, realigning and managing the interests of pension beneficiaries and their agents should be prioritized. Governance design, incentive structures and fiduciary practices are at the heart of this problem. However, given the varying organizational structures at different types of institutional investors and the environments within which they operate, a one-size-fits-all approach may not work. Pension funds, endowments, mutual funds and insurance companies may experience varying degrees of difficulty in shifting to a more balanced investment approach.⁴²

⁴² See *"The Future of Long-Term Investing," supra n. 25, p. 13 and following.*

IV. Suggestions and areas of reform

A. Industry conflicts, poor stewardship and better governance

Pension beneficiaries (which we will call “asset owners,” even though as a legal matter the assets are not owned by the beneficiaries but are held in various trust arrangements) will generally be best served by fund managers who consider the long-term risks associated with their asset allocations and portfolio constructions. Good stewardship, i.e. monitoring of those long-term risks, including environmental, social and governance (“ESG”) risks, and taking appropriate action where concerns arise, is an important strategy to protect the long-term sustainability of returns for asset owners. Notwithstanding growing demand for stewardship from some clients, fund managers are often reluctant to act as good stewards on behalf of their clients, and so the responsibility for voting and corporate governance evaluation and engagement is outsourced to specialist engagement overlay providers. There are a number of reasons for this reluctance. Two are particularly salient: the incremental costs of good stewardship reap benefits only in the long-run, and so not within the time frame of a fund managers’ mandate; and fund managers have business relationships with a range portfolio companies, such as managing pensions within companies, and so will be reluctant to vote against management or be perceived as corporate governance activists generally.

While delegation to engagement overlay specialists would seem to be an efficient solution, it undermines the power of engaged owners by decoupling the buy/sell decision from ownership activities. Who, really, will companies listen to, the engagement overlay provider or the fund managers who make buy or sell decisions? Moreover delegation ignores the fact that individual portfolio managers do huge amounts of engagement all the time, but focused on the short-term and using narrow financial metrics. By so doing, portfolio managers send messages to corporations that are sub-optimal if viewed through the lens of long-term responsible ownership.

Ultimately, this is an institutional investor governance problem. Research at pension funds has demonstrated that movement to investor best governance practices can improve performance by as much as one to two percent per annum.⁴³ The drivers for this enhanced performance include aligned interests (no conflicts); good board governance skills and accountability; sensible investment beliefs focused on long-term wealth creation and effective risk management; and sufficient asset size to attract competent personnel and pay them competitively.⁴⁴

B. Managing to benchmarks and paying for sustainable performance

Benchmarks have an important “infrastructure role” in asset management today. We assert that the dynamics of these assessment tools have not been seriously taken into account by regulators and other policy makers.

Benchmarks and asset management mandates: Most mandates to asset managers identify success as performance relative to benchmarks that are composed of indices relevant to the different asset classes into which the asset owners’ funds are being invested. Yet there is no necessary connection between the performance of the benchmark and the beneficiaries’ ultimate financial interests— fund managers may destroy value for the asset owner in absolute terms, but still outperform the benchmark. Benchmarks are used for ease of administration and for convenience in

⁴³ K. Ambachtsheer, R. Capelle and H. Lum, “*The Pension Governance Deficit; Still with US,*” Rotman International Journal of Pension Management, Vol. 1, Issue 1 (2008).

⁴⁴ K. Ambachtsheer, “*Building Tomorrow’s Pension Fund Today; From Vision to Reality,*” The Ambachtsheer Letter 297 (2010).

judging the performance of the asset managers; we believe it unlikely that the market will move away from them.

In general, it is possible to minimize the impact of agency issues and conflicts of interest, but they cannot be eliminated entirely. In most cases, the individual signing for the client is satisfied with the arrangements, as are the asset managers. Whether these arrangements serve the asset owners' interests is a separate matter. Clients, it turns out, have limited influence even when they try to change "standard" mandate arrangements. We are aware of rather substantial clients whose attempts to encourage a longer-term orientation and broader consideration of ESG factors in fund management mandates have been met with refusal by asset managers across the board, the common defense being that "none of our other clients have asked for this, we don't know how to price it, we won't do it." (We can provide Prof. Kay or his associates with the specific identities of the clients and asset managers involved in a confidential communication, if that would be appropriate.) In essence, the investment supply chain works in reverse: asset managers dictate the general terms (the tail wags the dog).

There are now important efforts being undertaken by the International Corporate Governance Network, *Model Mandate Initiative: Model Contract Terms between Asset Owners and Their Fund Managers*, to develop model mandates that reduce short-term pressures and expand consideration of ESG factors.⁴⁵ Better alignment of manager incentives with interests of end beneficiaries is a key part of the solution.⁴⁶ The terms of these model mandates could provide guidance to the Kay Commission for industry best practice in this regard. Another emerging practice is to include environmental, social and governance (ESG) factors into the design of indices and benchmarks, and to link stewardship activities to the index. This is a practice that we support.

Benchmarks, measures of success and reporting: While market-relative benchmarks might be appropriate for individual portfolios, overall fund measures of success and reporting obligations should be tied only to beneficiary/participant/investor risk-adjusted goals. Distinctions between short- and long-term investment schemes might also be appropriate. For pension plans and other long-term investment programs, marketing and overall measurement of success should not be based on less than five- or ten-year numbers and should identify different measures for different long-term time horizon investors (e.g., if you are saving for 40 years in the future, goals and benchmarks are different than for those saving for ten years into the future).

C. Lack of consistent, comparable, high-quality information necessary to inform those institutional investors that understand the need to take a long-term perspective

Asset owners are best served by discounted cash flow models that incorporate timely, accurate, and credible financial information, as required by regulation. Share prices would more accurately reflect fundamental values (albeit never perfectly) if companies were also to disclose environmental, social and governance information in consistent, comparable format, perhaps

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See: http://www.icgn.org/files/icgn_main/pdfs/agm_reports/2011/item_9.2_icgn_model_mandate_initiative.pdf

⁴⁶ Mutual funds with directors that have low ownership significantly underperform peer funds with boards that have high ownership of shares. M. Cremers, J. Driessen, P. Maenhaout and D. Weilbaum, "Does Skin in the Game Matter? Director Incentives and Governance in the Mutual Fund Industry," *Journal of Financial and Quantitative Analysis*, 44:1345 (2009).

using quantitative key performance indicators,⁴⁷ thus allowing fund managers to evaluate more accurately a broad range of risks. Active fund managers have an incentive to defend their competitive advantages, including with respect to information (i.e., having a superior ability to interpret available information), but have fewer incentives to promote broadly available information about companies. The aborted Operating and Financial Review (OFR), for example, gained less support amongst fund managers than might have been expected.⁴⁸ Narrative reporting is of more relevance to asset owners than to their fund managers, because it provides them with knowledge of companies potentially closer to that gained by fund managers in their ongoing dialogue with companies, enabling better oversight over their managers' investment decisions and stewardship activities.⁴⁹ Companies should be required to disclose specific environmental, social and governance data, including discussions of how boards of directors are evaluating human rights, social and environmental risks, and what stakeholder consultations inform the company's analysis. We submit that the requirements of the Business Review, now that they've been implemented for five years, are ripe for evaluation: How good is the information that has been disclosed, how specific, how useful?

D. Accounting standards that do not reflect externalities

If the long-term perspective that is articulated by leading institutional investors is to be translated into investment management, the quantitative tools that investors use must be considered. The language of markets is accounting. This point suggests a number of approaches to consider.

International Financial Reporting Standards ('IFRS') could be revised to include measures and reporting for positive and negative social and environmental externalities companies produce. So, for example, when companies invest in training their employees, that investment could be treated as a capital investment, not as a cost. When companies use water, produce greenhouse gas emissions or other pollution, undermine habitats, those could be treated as costs. Measures such as Yale University environmental economist Robert Repetto's 'True Economic Value Added', which incorporates measures of environmental harm into an integrated measure of financial results, have been developed with intellectual rigor and are ready to be implemented into national and international accounting standards.⁵⁰

Current professional and regulatory standards are major roadblocks to taking a longer-term approach to investing.⁵¹ The fair value approach assesses investment holdings as if they would all be sold immediately, even though pension funds and other long-term investors would require only a portion of assets to be liquidated in the worst of circumstances. Accounting and actuarial standards encourage short-termism and investment practices that often end up being pro-cyclical. Much could be done to explore development of alternative (or additional) valuation and

⁴⁷ For thoughtful discussions of key performance indicators see Robert Eccles and Michael Krzus' *One Report: Integrated Reporting for a Sustainable Strategy* (2010); The Institute for Responsible Investment (Steve Lydenberg and David Wood), *From Transparency to Performance: Industry Based Sustainability Reporting on Key Issues*; or DVFA (Alexander Bassen and Ralf Frank) *Key Performance Indicators for Extra-Financial Analysis*.

⁴⁸ See Cynthia A. Williams & John M. Conley, *Triumph or Tragedy? The Curious Path of Corporate Disclosure Reform in the UK*, 31:2 WILLIAM & MARY ENV. L.J. (2007)(discussing the OFR and its reversal).

⁴⁹ Local Authority Pension Fund Forum, *Holding Fund Managers to Account*, October 2006.

⁵⁰ Robert Repetto and Daniel Dias, 'TRUEVA: A New Integrated Financial Measure of Environmental Exposure', *Yale Center for Environmental Law and Policy, Working Paper No. 200602*, 15 October 2006.

⁵¹ The World Economic Forum report cited above, footnote 25, discusses these factors.

analytical approaches for the portion of assets held as long-term investments by long-term investors. Perhaps this could also be tied to new tax reductions for engaging in long-term investing.

The direct and indirect costs and risks of short-term investment strategies (especially for long-term investors) are rarely tied back to individual investment decisions. We need better mandated recognition, valuation and reporting of the transaction costs, management expenses/fees, ESG risks/opportunities and externalities offloaded to consumers/taxpayers/customers that are associated with renting, rather than owning, equities. The added value from creating positive externalities should also be captured and recognized at the asset valuation level. Work product of current efforts like the Global Reporting Initiative and International Integrated Reporting Council could be adopted through regulatory actions.

To take forward the ideas in this paper, we suggest that the Government should further develop research, education and dialogue with and by inter-disciplinary groups within academia and financial institutions, including beneficial owner representatives, in order to develop best practice comply or explain standards. Financial experts alone are not likely to develop the thinking necessary to reform finance in order to promote long-term sustainable economic development, although their expertise is clearly needed as part of the discussion. The current financial situation shows clearly the need for serious attention to how finance can better promote real economic development, and how long-term institutional investors can better contribute to that goal.

Conclusion

We appreciate the opportunity to provide the views of the individual participants of the Network for Sustainable Financial Markets named below.⁵² We commend the Government for taking up research and analysis of these important issues.

Sincerely,

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Dr. Clearfield adds as follows:

"The above signatory was the international portfolio manager at CREF responsible for its entire UK portfolio before, during, and after the transformations of UK financial markets from the mid-1980s to the mid-1990s. As a major user of those markets and a witness to the changes which took place then, it is his opinion that whatever other benefits might have resulted from this transformation, if any, the changes involved were almost entirely detrimental to the institutional investors participating in the markets, adversely affected their performance, and played a major role in the radical increase in short-termism throughout that period and subsequent to it. Thirty years ago, the brokers and sell-side analysts were forbidden to have positions on their own books; they were also accustomed to think in terms of protecting long-term relationships with fund manager clients. Despite their general interest in promoting more activity, this orientation encouraged them to be concerned about not 'burning' their clients, and to align their advice with the investment horizon of the client in question. (The existence of fixed commissions also meant that there was less of a necessity to churn clients in order to obtain a desired level of income.)

At the same time, the existence of distinct merchant bank advisors, who were not also involved in institutional sales, and who tried to maintain long-term relationships with issuers, as well as of a designated corporate broker, tended to provide a useful counterweight for issuers to the more emotional and short-term-orientated aspects of capital markets. The breakdown of relationship banking has encouraged more questionable deal-making, and more churn-inducing activity coming from the issuer side as well; uniting the two sides of the business into universal mega-banks has also created both a need for more activity in order to sustain a very high cost base, and a means to supply it by exploiting the investor. Worse, this has also encouraged a marked decrease in the ethics of most market participants.

He would earnestly recommend that the Commission re-examine the rationales behind those structural changes, the actual effects they have had upon both investor and issuer behaviour, and consider whether any structural reforms to the industry might be possible, in order to restore some elements of trust and ethical responsibility to it. Re-invigorating the advisory role, which used to be one of the financial services industry's chief products, and separating it from a commodity and volume approach to securities issuing and trading, would go far to reducing the emphasis on short-term performance and gaming of markets which blights both the industry and the economy today."