31st August 2012

Email: responses@coxreview.org.uk

Dear Sir George,

Thank you for the opportunity to comment on your review into the impact of short-termism on British business.

We welcome the decision of the Labour Party to commission an independent review into this subject; we are pleased to note that the issue of long-termism is attracting attention from a wide variety of political decision-makers as we believe there is an urgent need to restore public trust and legitimacy to equity markets in the wake of the financial crash.

Our response draws on our previous submissions both to the Kay Review of UK Equity Markets and Long-Term Decision Making in November 2011, and to the Financial Reporting Council on their proposed changes to the Stewardship Code in July 2012, as well as on comments made at past seminars on these topics by our members and other policy submissions.

We have focused our answers on Questions 1, 2, 4, 5 and 6 and have also proposed and answered an additional question about "closing the investment chain" through positive influence by companies on asset owners as part of our response to Question 6. The issue of "what's the cause of short-termism" as raised in Question 3, is partly answered in our responses to Questions 1 and 4.

We understand that you are currently conducting interviews with senior business practitioners and would be happy to take part in – or facilitate – this aspect of the enquiry in addition to the written submission below.

About UK Sustainable Investment and Finance Association (UKSIF)

UKSIF supports the UK finance sector to be a global leader in advancing sustainable development through financial services. We promote and support responsible investment and other forms of finance that advance sustainable economic development, enhance quality of life and safeguard the environment. We also seek to ensure that individual and institutional investors can reflect their values in their investments.

UKSIF was created in 1991 to bring together the different strands of sustainable and responsible finance nationally and to act as a focus and a voice for the industry. UKSIF's 260+ members and affiliates include pension funds, institutional and retail fund managers, banks, financial advisers, research providers, consultants and NGOs. For more information about UKSIF, please visit www.uksif.org.

Responsible investors as a group have been among the first to consider the risks and opportunities from long-term social and environmental challenges. Leading practitioners have a particularly strong understanding of the capital market failures which sometimes prevent investors from translating this knowledge into investment decision-making. We therefore believe that our organisation – and our members – are particularly well-placed to respond to this consultation.

Response to Review questions

Question 1: What are the timescales under consideration by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and managers in making investment and governance decisions, and to what extent do these match the long-term needs of the business?

In our response to the government's *Consultation on a Long-term Focus for Corporate Britain*, we noted that "long-term wealth creation and the interests of responsible capital providers is not well served by a range of current practices within capital markets and across the investment chain."[1]

Academic evidence

There is a growing body of academic and other evidence on short-termism in the investment chain. UKSIF has collated much of this evidence in our Sustainable Capital Markets Library, available at www.uksif.org.

UKSIF's Sustainable Capital Markets Library has been provided for those who influence or study the changing nature of the capital markets both within and outside the UK. It addresses particularly the impact of structures and incentives on long-term responsible investment. A brief summary of each article or report is given, with an additional link for access to the full document.

For example, the library includes the paper Lydenberg, S. 2007. "*Long-term investing: a proposal for how to define and implement long-tem investing"* which argues that: "excessive focus on short-term profits has various detrimental effects. It causes corporate managers to misallocate assets. It introduces dangerous volatility into financial markets. It means society must divert productive resources to repairing environmental and social damage done in the headlong pursuit of profits."

Other bibliographies and databases about market failures in the investment chain include the information and links maintained by the PRI Academic Network[2].

One particularly worthwhile paper is the "*The Economic Role of Finance",* the submission to the Kay Review consultation by participants in the Network for Sustainable Financial Markets (NSFM). It highlights a range of more recent academic research. NSFM includes both academics and practitioners and their response can be found at: www.bis.gov.uk/policies/business-law/corporate-governance/kay-review/kay-review-responses

[1] UKSIF response to BIS Long term consultation,14 January 2011 /www.uksif.org/cmsfiles/responses/UKSIF_Response_to_BIS_Consultation_on_A_Long-term_Focus_for_Corporate_Britain_14Jan11__2_.pdf

[2] http://academic.unpri.org/index.php?option=com_content&view=article&id=232%3Aresearching-and-publishing-current&catid=44&Itemid=100049#respubtop

We also welcome and support Professor John Kay's analysis and exploration of the issue of short-termism in equity markets, concluding that "short-termism is a problem in UK equity markets, and ... the principal causes are the decline of trust and misalignment of incentives throughout the equity investment chain"[3].

Beneficiary opinion / public opinion

There is evidence that the public supports long-term responsible investment approaches. Opinion poll research conducted in September 2011 by YouGov[4] for UKSIF found that:

- **53%** of GB adults with investments believe **financial products that take social and environmental issues into account have an important, or very important, part to play** in the long-term growth of the UK economy.
- **58%** of all GB adults believe that **employer's pension schemes should match or beat the standard set by the new NEST workplace pension scheme in their approach to managing social and environmental issues** before they are allowed to qualify for 'auto enrolment' from October 2012.
- **23%** of GB adults with investments said **their financial adviser or pension fund told them 'too little' about 'responsible ownership'**; rising to **30**% amongst 45-54 year olds.

Industry research

A range of studies have been published by the investment industry and its stakeholders about long-term responsible investment. There are also a number of continuing and past investor initiatives on the topic.

UKSIF maintains information on an edited selection of these, particularly for use by occupational pension funds, in its Sustainable Pensions Library, available at www.uksif.org.

Asset owner timescales

Although we have not collated evidence on asset owner timescales as major investment consultants are best placed to advise on this, our members frequently comment that even long-term institutional investors such as pension scheme trustees tend to monitor and review fund managers on short timescales.

Some members also say that pension fund trustees often have insufficient time and/or appetite to develop their skills in procurement and oversight of responsible ownership or long-term investment mandates.

Nevertheless, there are some positive signs of longer-term thinking by asset owners – which are described in greater detail in our response to Question 6 below.

[3] Final Report of the Kay Review, p.9: www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf

[4] You Gov opinion poll Sept-Oct 2011 for National Ethical Investment Week 2011. Data at http://www.neiw.org/about/media-centre/green-and-ethical-market-spreads-its-wings and http://www.neiw.org/about/media-centre/ifas-urged-gain-green-advantage. Total sample size was 2105 adults. Fieldwork was undertaken between 28-30 September 2011. The survey was carried out online. The figures have been weighted and are representative of all GB adults

Question 2: Is 'short-termism' – the pressure to focus on short-term performance to the detriment of the long-term development of the business – really an issue? And if so, to what extent?

There is growing evidence to show that an excessive focus on short-term performance is an issue, as competitive strengths can derive from addressing key, long-term mega-trends like climate change.

In this regard, we believe that Professor Kay has, in his Review, developed an excellent analysis of why short-termism is an issue for UK companies and savers and "identified many cases in which poor decision-making had damaged the long-term success of the company" citing, in particular, the examples of ICI and GEC, and that "short-termism in business may be characterised both as a tendency to under-investment...and as hyperactive behaviour by executives whose corporate strategy [does not develop]...the fundamental operational capabilities of the business"[5]

However, we also believe that recent years have shown an increasing capacity within the investment chain to analyse the competitive strengths that arise from addressing long-term trends through an environmental, social and governance (ESG) lens.

Materiality of a long-term focus for corporate performance

The Impact of a Corporate Culture of Sustainability on Corporate Behaviour and Performance, a recent working paper from academics at Harvard Business School and London Business School[6], concluded that companies with a strategic focus on long-term, ESG issues show financial outperformance, and a stock market and accounting value premium after three years. They found that the premiums continue to rise in further years.

This builds on earlier research supported by the UNEP Finance Initiative Asset Management Working Group which concluded that selected ESG issues are material and affect shareholder value in both the short and long-term[7].

Buy-side and sell-side analysis

Over the last ten years in particular, significant capacity has developed within asset managers,"sell-side" investment banks and independent research providers to assess the competitive strengths of companies using ESG analysis.

For example, UKSIF's membership includes a number of leading investment banks[8] and independent investment research providers[9], including Bloomberg and Thomson Reuters, who provide ESG support and are UKSIF members.

ESG analysis capacity is recognised in the annual Thomson Reuters Extel and UKSIF Sustainability and SRI Survey Awards which celebrated their tenth anniversary in 2012[10]. The 2012 Survey represented the views of over 500 investment professionals from 27 countries (an increase from 2011, where approximately 400 professionals from 23 countries took part). Votes were cast from 228 buyside

[5] Kay Review, p10, p18.
[6] http://www.hbs.edu/research/pdf/12-035.pdf
[7] Eg. Linking Environmental, Social and Governance Issues to Company Value (UNEP FI, 2006) http://www.unepfi.org/fileadmin/documents/show_me_the_money.pdf
[8] www.uksif.org/members/member-directory/investment_banks
[9] http://www.uksif.org/members/member-directory/research_advisory
[10] www.uksif.org/cmsfiles/press/5390331/Extel_UKSIF_SRI_Awards_2012_FINAL.pdf

firms and 29 brokerage firms/research houses (up from 209 buyside and 20 brokerage companies respectively the previous year). Brokerage firms recognised for their research included CA Cheuvreux, Bank of America Securities – Merrill Lynch, UBS and HSBC.

Examples of ESG research are available from the London Accord project at www.longfinance.net/programmes/london-accord.html.

Question 3: What's the cause of short-termism?

Please see our response to Questions 1 and 4.

Question 4: To what extent, if any, does it have an effect on the sector/economy as a whole?

As the world faces the challenges of environmental limits and associated social change, public capital markets that operate in the long-term interests of companies, savers and society as a whole have a vital role to play in driving the massive capital reallocation needed to enable economies to respond.

We believe that investment is not currently being efficiently directed towards those sectors which – like green infrastructure – are necessary for delivering the long-term sustainable growth in those areas which will allow the UK to continue to compete in a changing world. Although measures like the Green Investment Bank should help in the narrow example of green infrastructure we quoted above, equity markets similarly need to change in order to enable companies and investors to better take account of long-term factors in their decision-making.

Professor Kay described the effects of short-termism eloquently in his Review, saying: "Short-termism in business may be characterised both as a tendency to under-investment, whether in physical assets or in intangibles such as product development, employee skills and reputation with customers, and as hyperactive behaviour by executives whose corporate strategy focuses on restructuring, financial re-engineering or mergers and acquisitions at the expense of developing the fundamental capabilities of the business...we consider that equity markets have evolved in ways that contribute to these errors of managerial judgment".

And in 2009, UK government adviser Sir John Beddington warned that in coming decades the UK "must address rising demand for food, energy and water, while mitigating and adapting to climate change"; we have also most recently seen similar recognition of these issues on a global scale at the Rio+20 Conference in June 2012 with Caroline Spelman, UK Secretary of State for the Environment, Food and Rural Affairs, saying: "...we face a twin challenge: to eradicate poverty and drive up living standards while living with finite resources. In my view, this can only happen by ensuring that we promote sustainable and inclusive growth...the world's economy activity must be green, it must be sustainable, and it must enhance societal progress. The green economy cannot just be a subset of the global economy, and it must be inclusive".

Contribution of long-term responsible investment skills to international competitiveness of the UK finance sector

The need to reallocate capital to address environmental and social change provides both an opportunity and a challenge for UK financial services.

The UK sustainable and responsible finance industry is widely recognised for its global leadership in long-term investment:

- It manages approximately **13%** of the responsibly managed assets tracked by sustainable investment and finance associations globally[11].
- It ranks **second** globally in the number of signatories to the UN-backed Principles for Responsible Investment with 143 signatories, behind the USA (158) and ahead of Australia (124)[12].

The growing number of PRI signatories globally demonstrates both increasing demand for long-term investment skills and the growing competition to supply these. Addressing market failures that impede long-term investment approaches can therefore be an important contributor to the competitiveness of the UK finance sector and to the economy as a whole when viewed through a UK skills-base lens.

Please also see Question 2 for further thoughts that are relevant to this question.

Question 5: What role, if any, does government have in driving a more long-term approach within UK business?

We believe that there are several areas where government could be instrumental in facilitating a more long-term approach by UK businesses:

Stable regulatory frameworks that drive long-term competitiveness

Government policy has most potential to influence investors and corporate boards to focus on the long-term through its regulation of externalities – such as its policies on climate change. This has widespread investor support. For example, in October 2011, 285 investors representing over 20 trillion US dollars in assets stressed the need for effective climate policy action and a recent report by UNEP FI and others underscored the importance of "investment-grade" policy. The report emphasised that long-term policy stability is critical and retroactive changes can significantly damage investor confidence[13]. Similar points have recently been made regarding the energy and low-carbon sectors specifically by a variety of green business and consumer groups[14].

Sustainable public procurement

The scale of public sector budgets means sustainable procurement by Government[15] has significant potential to encourage a more long-term focus by companies and to raise the importance of this to their investors. Today, there is a range of tools and material to support sustainable public

[11] Latest figures available as at July 2012.
[12] http://www.unpri.org/signatories/index.php?country=Country Accessed 29th August 2012
[13] http://www.iigcc.org/__data/assets/pdf_file/0019/15283/2011-Global-Investor-Statement-Press-Release.pdf
[14] www.r-e-a.net/news/letter-to-pm-and-dpm-urging-clarity-on-renewables-growth-and-support
[15] National Sustainable Public Procurement Programme, DEFRA, March 2011; Government procures a wide range of goods and services, spending around £236 billion annually-http://sd.defra.gov.uk/2011/03/the-national-sustainable-public-procurement-programme/

procurement. For example, the Commission for Sustainable London 2012[16] has produced material on good practice in sustainable procurement by government from companies.

Other

Based on our members' knowledge and experience, we also believe that government interventions to improve the investment chain would be particularly valuable in the following areas:

1. **A deeper debate on executive remuneration.**

   We are pleased to note the current trend for consultations by BIS and other organisations on narrative reporting and executive pay, as well as the Kay Review and this call for evidence. However, we believe that a deep and constructive debate specifically on incentives and pay within the investment chain has not yet taken place.

2. **Boosting Asset Owner Demand**

   This could include:

   - Guidance for pension fund trustees and other fiduciaries on the effective implementation of their fiduciary responsibility. The recent Charity Commission guidance "Charities and Investment Matters: A guide for trustees (CC14)" is a good example of such practical guidance. Furthermore, one of the most positive recommendations of the Kay Review was its proposal that the Law Commission should review the legal concept of 'fiduciary duty[17]' as it applies to investment, in order to better guide trustees.
   - Improved mandates, e.g. the International Corporate Governance Network has developed a long-term investment mandate template.
   - Improved selection and scrutiny of investment managers. Investment consultants have developed manager assessment techniques and made recommendations on ways for trustees to scrutinise performance in responsible ownership and ESG integration. Greater use of this support is now needed.

3. **Improving Procurement & Financial Literacy**

   This could include:

   - Encouragement and support by employers and plan sponsors in both the private and public sectors.
   - Improved public procurement of investment services, with a binding requirement for significant asset owners in or influenced by the public sector to become signatories to the UN-backed Principles for Responsible Investment (PRI) and leaders in PRI implementation.
   - UK legislators to act as role models through leadership in responsible investment by the UK Parliamentary Contributory Pension Fund.

[16] Sustainably Sourced, CSL October 2011 http://www.cslondon.org/2011/10/commission-publishes-sustainability-review-of-london-2012-merchandise/
[17] See Chapter 9: "Fiduciary Duty", Kay Review.

- Improved understanding of the true role of equity markets as long-term allocators of capital in school based education and public awareness. This includes a role for companies and the public sector to improve the understanding of employees benefitting from workplace pensions and savings.

4. **Boosting the application of fiduciary standards across the investment chain**

   We support Kay's approach to, and exploration of, this issue and agree with his analysis that "all participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers" and that "regulatory obligations in the equity investment chain should be raised to fiduciary standards[18]". In order to achieve this, Kay recommended that "regulatory authorities at EU and domestic level [such as the FSA] 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"[19].

However, we believe that government regulation itself is insufficient and too great a regulatory burden can be counter-productive; an effective response that ensures better-functioning capital markets requires action from all parts of the investment chain – albeit with some government encouragement. For this reason, we have proposed the following additional question on "closing the investment chain" through positive influence by companies on asset owners:

Additional Question: Should UK companies use their influence to encourage 'long-termism' in the investment chain?

In addition to their role as long-term investors, companies can play a vital role in improving long-termism in the investment chain through their influence on corporate pension funds, employees and other stakeholders.

UKSIF research has found that a large number of corporate pension funds are still lagging behind the leading schemes in their approach to long-term investment.

For this reason, government should influence leading companies to assist and encourage their corporate pension funds to implement long-term investment practices.

Government should also encourage companies to educate employees, customers and suppliers about the value of long-term investment practices.

Evidence from the UKSIF Sustainable Pensions project

Since 2006, UKSIF's Sustainable Pensions project[20] has assisted UK occupational pension funds to adopt more sustainable and responsible investment strategies. Project research has included three biennial surveys in 2007, 2009 and 2011 of the responsible investment practices of the UK corporate pension funds of companies that are corporate responsibility leaders.

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[18] Ibid.
[19] Ibid.
[20] www.uksif.org

The 2011 UKSIF *Responsible Business: Sustainable Pension* report was based on questionnaire responses from UK corporate pension funds of companies included in the FTSE4Good Series and the Carbon Disclosure Leadership Index in January 2011. The results indicated a step change in how corporate pension funds were responding to the case for responsible investment, with some impressive examples of excellent practice. Equally positively, it demonstrated that pension funds that started on the responsible investment journey tended to deepen their practices over time. Nevertheless, it found that a very large number of UK corporate pension funds are lagging behind the leading schemes in their approach to responsible ownership and investment.[21]

The research suggests that plan sponsors would have influence if they encouraged their corporate pension funds to require long-term responsible investment approaches. According to the 2011 survey, three fifth of funds with a responsible investment (RI) policy gave "some" or "great" significance to alignment with the plan sponsor's sustainability policy. One third gave "great" significance to this. Both proportions were broadly unchanged from 2009. In addition, participating funds identified a range of benefits from their RI policy. These included mitigating reputational risk associated with the sponsor covenant (i.e. protecting the sponsor covenant by reducing the risk that the pension fund would threaten the reputation of the employer).

As well as providing assistance and encouragement, companies can help corporate pension funds to implement long-term investment practices by proposing appropriate employer-nominated trustees. The 2009 UKSIF *Responsible Business: Sustainable Pension* survey found that leadership in responsible investment was being driven by trustees. The 2009 report recommended "Plan sponsors might be asked to identify appropriate employer nominated trustees … The Environment Director, HR Director or CSR Manager may all be suitable candidates."

Question 6: The financial crisis has had far-reaching implications for the business environment and for the economy as a whole. Are there any signs that either firms or investors have been changing their behaviour since the financial crisis?

In terms of asset owner behaviour, there have been some positive results over recent years; these include the results of UKSIF's 2011 *Responsible Business: Sustainable Pensions* survey described in our response to Question 5 above. This survey found evidence of the trend identified by Eurosif in its 2009 study, *Investment Consultants and Responsible Investment*, where 89% of investment consultants anticipated an increase in clients' interest in ESG matters in the following three years[22].

Engagement Capacity

The recent "shareholder spring" – where investors have been increasingly active in remuneration and other votes at company AGMs – is a positive development, although it is merely the tip of the 'engagement' iceberg. That is, that engagement is about more than taking part in a vote, it is instead a longer-term approach taken by investors and companies to deepen the dialogue on corporate practice, behaviour and management, ensuring that shareholders derive value from their holdings. This could include, in addition to policies on voting and voting disclosure, the monitoring of investee companies or meeting with a company's Chairman or senior management, amongst other practices.

[21] 'Sustainability escapes funds', FTFM, 28 August 2011, http://www.ft.com/cms/s/0/590e4c54-cfe1-11e0-a1de-00144feabdc0.html
[22] http://www.eurosif.org/research/investment-consultants-and-responsible-investment

Although, by its very nature, engagement is difficult to quantify, UKSIF members have reported both a deepening of engagement capacity within asset managers and owners as well as a greater willingness on behalf of companies to listen to – and interact with – their shareholders on key issues which include strategic direction, executive remuneration and environmental, social and governance issues. The impact of the Financial Reporting Council's (FRC) Stewardship Code on raising the profile of the concept of 'good stewardship' and corporate governance should also not be underestimated and the FRC have stated that they are pleased with the numbers of organisations who have signed up to the Code, though they are particularly keen to boost asset owner take-up.

Integrating ESG factors into investment

As explained above, there is evidence that competitive strengths can derive from the taking of long-term economic, social and governance (ESG) factors into account in the decision-making of companies and investors – and that the capacity to do so within the UK has improved over recent years.

One good indicator of this is the number of signatories to the UN-backed Principles of Responsible Investment. These Principles aim to help investors incorporate ESG issues into their decision-making and ownership practices by providing a voluntary framework. The number of UK signatories to the PRI were given in our response to Question 4 but it is worth noting the increase in UK signatories over the last few years[23]:

Signatory Category	Summer 2012	Summer 2010	% Increase
Asset Manager	84	57	47%
Asset Owner	28	22	27%
Professional Service Provider	27	26	4%

The number of asset manager signatories in particular has increased by nearly 50% since Summer 2010; a positive indication that UK fund managers are now engaging with more responsible, more long-term business strategies. We understand from well-placed practitioners that their interest is genuine and will lead in time to further deepening of practices.

We trust that our comments will prove to be self-explanatory but if you would like any further clarification, I hope that you will not hesitate to contact us.

Yours sincerely,

Penny Shepherd MBE
Chief Executive
UK Sustainable Investment and Finance Association (UKSIF)

[23] www.unpri.org/signatories/ Accessed 31st August 2012.