18 November 2011

Our ref: ICAEW Rep 106/11

The Kay Review
Department for Business, Innovation and Skills
Spur 2, Floor 3
1 Victoria Street
London
SW1H 0ET

Dear Professor Kay

The Kay Review of UK Equity Markets and Long-Term Decision Making

ICAEW is pleased to respond to your call for evidence on *UK Equity Markets and Long-Term Decision Making*.

Please contact me should you wish to discuss any of the comments raised in the attached response.

Yours sincerely

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ICAEW REP 106/11

ICAEW REPRESENTATION

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

Memorandum of comment submitted in November 2011 by the ICAEW, in response to Professor Kay's call for evidence on UK Equity Markets and Long-Term Decision Making published in September 2011

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the call for evidence *on UK Equity Markets and Long-Term Decision Making* published by the Kay Review on 15 September 2011, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The submission draws on consultations with ICAEW members with experience and expertise in relevant areas including corporate finance, financial services, finance and management, sustainability, audit and corporate governance.

SUPPORT FOR THE INITIATIVE

5. We welcome the Kay Review's call for evidence and emphasise our commitment to working constructively with the Kay Review so as to improve understanding of the factors that support the performance and growth of quoted companies and promote investor returns as well as those factors that might hinder those objectives.

6. We are keen to help develop thinking and to provide, through consulting the various interests represented among our members, a constructive sounding board and test bed for ideas or proposals that are aimed at strengthening supportive factors and addressing hindrances. In this respect, we reiterate the offer of assistance to the Kay Review set out in the email to Helen Whitehead of BIS from Katerina Joannou, dated 13 October 2011.

7. We set out our comments on the call for evidence in the following section together with our recommendations. These address:

a. shortcomings of the process (paras 8 – 10);

b. our concerns at presumptions in the call for evidence (paras 11 – 13); and

c. areas in need of research (paras 14 – 19).

COMMENTS ON THE CALL FOR EVIDENCE

a. Shortcomings of the process

8. It is essential that the Kay Review demonstrates it has gone through due process to access all available evidence and that its findings are based on insights from a comprehensive view of that evidence. Uncertainty in the economic climate and internal cost control requirements mean that firms and businesses will not prioritise collecting hard evidence in the form preferred by the Kay Review, particularly within the short consultation period. Many of the firms we have spoken to, including professional services firms and brokers, will also refrain from submitting a response to questions about behaviour where their only evidence to support their insights is direct personal experience. We strongly believe that such experience provides valuable insights and we also consider it important to set out areas that lend themselves to more formal research, as explained further below.

9. We are also concerned that certain relevant market participants appear not to be directly addressed; examples of these are providers of credit and other sources of capital, regulators such as the Pensions Regulator and Charities Commission and participants such as the purchasing and supply profession. It is important to realise that many organisations that have evidence in a particular area may be disinclined to respond if they only have contributions to make in that particular area, or if they assume that other bodies will respond. The Kay Review may therefore find that focus groups could help supplement any gaps in respondent groups.

10. We note the call for evidence includes areas which are the subject of previous or current consultations; namely Effective Company Stewardship: Enhancing Corporate Reporting and Audit (FRC, January 2011); Green Paper on the EU Corporate Governance Framework (European Commission, April 2011) and discussion papers on Narrative Reporting and Executive Remuneration (BIS, October 2011). It is important that the Kay Review takes into account the related submissions and findings.

b. Presumptions

11. The difficult conditions in which UK equity markets are operating deserve full recognition and ICAEW is committed to supporting and promoting the confidence of companies, investors and the range of market participants. In this spirit we would sound two notes of caution, the first relating to an apparent presumption that a short-term focus is always bad and the second to an apparent presumption that internationalisation of UK share ownership is undesirable.

12. The first presumption ignores the range of legitimate incentives and, therefore, time horizons that operate in well-functioning markets. As set out in ICAEW's response (ICAEW 07/11) to A Long-term Focus for Corporate Britain – A call for evidence, such a presumption is unsubstantiated. We do agree however with the aim of evaluating the range of time horizons and their implications for company growth and investor returns. An alternative way of looking at this may be to identify the problems that short-termism is believed to create and to highlight what steps can be taken to address those problems. There is a real danger of tackling a perceived issue of short-termism in isolation without properly understanding the role that short-term considerations play in the capital markets and thereby creating a new set of problems. In particular we would be apprehensive about any regulatory measures that seek to distinguish between short-term and long-term holdings and that penalise short-term holdings. For example, we would be against placing voting restrictions on shares held short-term or increasing shareholder rights for long-term holders.

13. Given the status of London as an international equity market, we would also not support a second presumption that the internationalisation of UK share ownership and UK company activities is undesirable. The ability of UK companies to access international capital is essential and internationalisation of UK share ownership is also a way of promoting UK governance and stewardship standards. Moreover the UK has always been an open economy and its companies have had an international outlook and as a result of these factors the UK is an international business centre.

c. Areas in need of research

The ability of smaller companies to access equity capital

14. We believe it would help the Kay Review's objectives to further research how well UK equity markets serve the ability of smaller companies to access capital markets. This is, we believe, aligned to the government's wider business growth agenda.

15. The Kay Review could seek to establish evidence on whether the benefits to smaller quoted companies of access to wider sources of capital and adherence to acknowledged standards in reporting and governance may be reduced by:

- the cost of the IPO process and continuing obligations for listed companies;
- further fundraising activities facing competition from a wide range of investment products;
- the limited number of small cap fund managers who could provide visibility to smaller companies; and
- the market making system and its impact on liquidity and share prices and thus on growth potential.

The environment for holding shares

16. Company growth is influenced by the ability of companies to fund plans and this would include raising additional capital. Investor returns are influenced by the ability of companies to act according to their owners' needs. The Kay Review should therefore explore factors that create apparent disincentives for holding shares for both retail investors and institutions, as explained below.

17. Participation of retail investors in IPOs and secondary fund raisings is not common. This is due in part to the prevalence of placings for small cap IPOs but some also question whether the flow of information from fund managers to the end investors in pension and life products is appropriately tailored and, therefore, whether it encourages shareholders to take an interest in the companies in which they hold a stake.

18. From an institutional perspective, members cite the obligation of trustees to minimise risk and match assets to liabilities, which means that pension funds gravitate towards gilts or other instruments that are perceived as safer than equities.

19. The holding of equity is also influenced by factors such as

- stamp duty and capital gains tax;
- doubts about whether companies provide shareholders with the information they want and need and in a useful form; and
- the level of engagement between companies and their management with shareholders.

The Kay Review could explore further whether reforms in these areas are required, although there would be a need to guard against unintended consequences.

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