Tomorrow's Capital Markets

Investing in what we value

tomorrow's company

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Investing in what we value

Foreword

We believe that the capital markets have a major role to play in supporting companies as they tackle the challenges facing the world.

This report sets out our vision for a capital markets system that would perform this role more effectively.

It describes and welcomes signs of positive change and suggests how these may be built upon and we offer our recommendations.

It also identifies difficult issues that will need deeper examination before clear solutions can be agreed.

We therefore encourage those at the forefront of change to persevere with their efforts. And we encourage those who are sceptical to give time to listen to the advocates for change.

As signatories to this report, we are committed to doing all we can to apply these ideas and stimulate practical progress.

We particularly hope that this report will prompt further discussion and exchange of ideas about the evolving role of capital markets. Its ultimate success will be measured by the actions that leaders and others across the system take.

The opinions expressed, and the designations and terminology employed in the report, are the sole responsibility of Tomorrow's Company.

Comments on this paper are invited and may be addressed to the authors at tcm@tomorrowscompany.com.

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Introduction

This report brings to a formal conclusion the research into Tomorrow's Capital Markets, which began in 2010. The purpose of the programme has been to explore how the operation of incentives, both hard and soft, within the capital markets system could be better structured to get resources channelled to where they can be most productively used for long-term human development while producing sufficient return to incentivise market participants to invest.

Progressive companies recognise that creating long-term value depends on understanding the interdependency between financial, social and environmental factors. Companies also have the innovative capability and capacity to produce the solutions to many of the challenges facing the world. The role of capital markets is to channel excess savings to where they can be most productively used and we need capital markets to reward these companies with the capital they deserve.

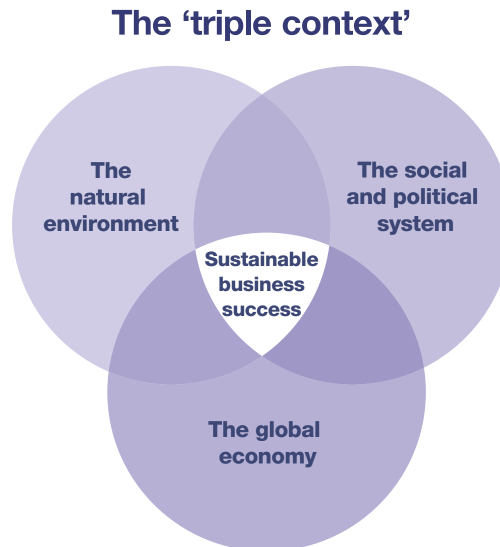
An initial report *Tomorrow's Capital Markets: an invitation to work with Tomorrow's Company to set new incentive structures for a sustainable world* was published in 2012.[1] This set out an agenda for change for further discussion (*see appendix*). Critically, the report recognised that change needs to be created and owned by those in the system and those who are responsible for the system. Against a constant backdrop of continued public outrage, growing shareholder activism and ever greater scrutiny of the system by regulators, particularly in terms of remuneration and charges, we believe that change that comes from within is preferable to change imposed from outside. Interventions need to be carefully judged and require both a systemic and collaborative approach.

Developing this agenda has been the focus of this second stage of inquiry. We have therefore moved beyond the diagnosis to test and refine the findings of the first report. We also recognise that although capital markets are global, aspects such as regulation, reporting and listing still remain national. For this reason, we have chosen to focus on the UK, and to a lesser extent the EU. However, many of the principles behind the findings are just as applicable in other regions.

At the heart of our approach has been a focus on broadening our engagement with participants in the system, harnessing their wealth of experience to generate ideas that build on good practice but still challenge the system to evolve further. Those who have been involved throughout both stages of the programme have done so because they are interested in the role of capital markets in supporting companies and they want those markets to better contribute to long-term business success. Capital markets are hugely important to the economy. Well-functioning capital markets fuel growth by mobilising savings and diverting them into productive investment. They encourage greater diversity in funding which reduces concentration of risk and strengthens stability. They provide the means for ordinary people to save with the prospect of a fair return. The amount of money available is vast.

As a society we are facing unprecedented challenges across the spectrum of the environmental, social and political and global economic sub-systems that make up the global system as a whole. Tomorrow's Company calls this the 'triple context'. These three systems are by their nature interconnected. Population ageing is happening on a scale unparalleled in human history bringing with it the need to create a long-term, sustainable infrastructure for retirement provision. Shifts in population, economic growth and patterns of consumption are straining our natural systems creating unsustainable impacts in respect of climate change, energy, food supply, and freshwater. We are moving into a world of energy challenges. Businesses are finding it harder and more costly to access the resources they need. All of these factors present their own challenges as well as interacting in complex ways.[2]

The ‘triple context’



It is predicted that by 2050, the number of older people (aged 60 or older) in the world will exceed the number of young people (under age 15) for the first time in history. The over 60s will make up 22% of the world’s population. In the UK there are ten million people over 65 and this is likely to grow to around 19 million by 2050.[3]

Recent estimates by the UN Population Division conclude that instead of leveling off in the second half of the 21st century, as the UN predicted less than a decade ago, the world’s population will continue to grow beyond 2100.

Today humanity uses the equivalent of 1.5 planets to provide the resources we use and absorb our waste. This means it now takes the Earth one year and six months to regenerate what we use in a year. Moderate UN scenarios suggest that if current population and consumption trends continue, by the 2030s, we will need the equivalent of two Earths to support us.[4]

According to the UN’s Food and Agriculture Organisation, a total of $83bn a year must be invested in the agricultural sector of developing nations if there is to be enough food to feed the world’s population of 9.1bn in 2050. This is an estimate of the “*level of investment required to meet growing demand for food in 2050 – not to eliminate hunger”.*[5]

Agriculture accounted for 92% of the global water footprint in the period 1996-2005.[6]

Of all the water on Earth, just 2.5% is fresh water which is an essential input for all biomass growth and hence for all ecosystem services and associated jobs and livelihoods. But more than 1 billion people lack access to clean drinking water and 2 billion lack adequate sanitation.

At the beginning of 2015, São Paulo, the economic heart of Brazil, was in crisis as a result of severe water shortage. This led to an exodus from the city and illegal well drilling which is threatening pollution and raising public health risks. Economists predicted that the crisis could shave 1% to 2% off a GDP forecast of zero growth in 2015 so throwing the economy into recession.[7]

Global demand for energy is expected to rise by 37% from 2013 to 2035, or by an average of 1.4% a year.[8]

This rapidly changing context presents new opportunities and new risks for investors in the markets. How can these challenges be addressed by funding the growth and innovation needed without robbing the future to pay for today? How do we get resources channelled to where they can be most productively used for long-term human flourishing while producing sufficient return to incentivise market participants to invest?

The capital markets system is a hydra – a beast of many heads. An ugly beast, maybe. But one that has proven to be remarkably successful over the generations at fuelling economic growth and prosperity. That does not mean the system is perfect. Far from it, it has stumbled and fallen many times over the years. But it is resilient. Every time it has fallen it has recovered, it has adapted to a changing context and it has reinvented itself. Thinking differently, pushing the boundaries and finding alternative solutions are inherent characteristics of many who work within the system. It is these same abilities that can also be harnessed to change the system to address the challenges we set out in this report.

The system is currently going through one of the rockier periods in its history. Extensive diagnosis has been undertaken of the last financial crisis and numerous reviews and studies have been conducted into different parts of the system. The charge sheet of failings levelled at it is great. It includes a failure to understand risk, excessive greed, too much intermediation, conflicts of interest and chronic short-sightedness. We have heard repeated concerns expressed about behavioural and structural impediments that still exist such as:

- too narrow a view of value confined to only financials
- incentive structures that reinforce unhelpful behaviours
- the need for more collaboration from the way investors engage with management, to voting and the analysis of – and investment in – long-term infrastructure projects
- the impact of the 'casino economy' – a widely used term during and following the global financial crisis – in terms of undue volatility and distortion of the market[9]
- cultures that foster greed and excessive risk taking.

None of these charges is trivial. None can be addressed overnight.

However, if there is some hope to be drawn from the research that underpins this report, it is that many of the players within the system have started to recognise the need for change.

And this recognition is not pure rhetoric. There is much to build on. Over the past two years, the signs of change that we identified in the first report have continued to gain momentum. The debate around how capitalism needs to be reinvented to address the significant challenges we face as a society has continued to grow. Initiatives focused on understanding the impact of and opportunities presented by these challenges are gaining traction. The evolution of the system has started another cycle.

As we have progressed through this project, we have seen some key players starting to act. We have come across many examples of players across the investment system who are using extraordinary creativity to meet the new demands that the changing global context demands. Whether it is the quality of risk disclosures, or the level of scrutiny given to longer horizon issues by investment professionals, there are early signs of an appetite to evolve, learn and adapt to a changing world context. We seek to encourage this and build on existing good practice.

And it is not only the current generation of leaders in the system that we wish to encourage. The challenges we face as a society are intergenerational and so must be the responsibility for change. The generations that will follow will be ones that will live with the consequences of decisions we take today as asset owners and managers and intermediaries. These generations will have just as important a part to play in reshaping the system. Increasing their awareness of the issues we discuss in this report…of a different vision for the role that the capital markets system might play as an integral part of society…and strengthening their ability to make choices as a result are all crucial.

In seeking to encourage change, we have observed that there are still two main 'tribes' within the system. There are those who are often crudely labelled as the 'mainstream', i.e. asset managers investing savers' money in shares and bonds, using traditional benchmarks of performance and there are the 'change activists' who are calling for a greater focus on the concept of stewardship and the longer term. The 'change activists' are embracing a wider view of how value is created and tend to use their own language in ways that those in the mainstream can find too 'alternative' and off-putting.

In presenting our findings and recommendations it is inevitable that we will use terms such as sustainability, stewardship, Responsible Investment (RI), Socially Responsible Investment (SRI) and Environmental, Social and Governance (ESG).

We could try to invent a new language in the hope that the messages may 'land better'. But when we have dug deeper into discussions and got beyond the different labels, there is often little disagreement at a fundamental level. Most investors want to keep risk within limits that are acceptable to them and have a return that fulfils their present and future goals in a way that does not harm their future well-being, their families or others that they know – in aggregate this means society!

In a world of complex interconnected global financial, social and environmental challenges…where risks to our future wellbeing are both pressing and harder to identify but which also provide huge opportunities…where value is co-created through strings of trusted relationships that often span the globe…where traditional financial models, economic theory and thinking are no longer fully fit for purpose… where does 'mainstream' end and 'alternative' begin?

'Mainstream' thinking is simply the view of the majority…and the prevailing view is changing. What more can be done to nurture the shifts taking place and nudge the system further towards being more focused on a wider view of value and greater stability to enable this value to be realised?

For those of us who have been involved with this study, the answer is clear. It is about understanding that value is multi-dimensional rather than simply financial. It is about building risk resilience now and for the future. It is about identifying the opportunities that come from dealing with challenges we need to urgently address. And it is about recognising that addressing these challenges and achieving acceptable, if not superior, risk adjusted returns are not incompatible aims. It is only by addressing the issues we face as a society that we can secure a future in which any pension promise delivers an acceptable standard of living, both in financial terms and in living conditions.

In a nutshell, it is about trying to ensure that we are not investing our money only to end up in a miserable world and investing in what we value to secure the well-being of us all.

Our vision

We start by setting out our vision for the system. One in which long-term financial value is understood as meeting human needs on an intergenerational basis, takes account of economic, social and environmental factors, and is measured using a broad range of indicators.

This is achieved by ensuring that:

- a wider view of value is adopted and reflected in the information provided to support decision making
- savings are channelled into investments which create wealth and secure well-being
- strong investment performance is pursued over the long-term through a focus on stewardship, underpinned by collaboration and standards of integrity and transparency, and all the intermediaries in the system publicly declare the extent of their commitment to act in this way and explain how they fulfil these obligations
- long-term value creation is reinforced through aligning skills and linking targets and incentives to the needs of clients and beneficiaries
- there is an appropriate balance between long-term investments and the need for liquidity, and
- the scale and activity of what some refer to as the ‘casino’ economy does not pose a threat to the operation of the ‘real’ economy, while recognising the need for sufficient, but not excessive, trading to enable the real economy to operate effectively.

We believe this vision is best achieved by values-led, market based self-regulation wherever possible to reduce the need for imposed rules by regulators.

Rules can create a ‘tick-box’ compliance mentality and cannot cover every eventuality that will arise and can stifle innovation. Regulation adds cost and inefficiency so, before they are enacted, there must be a strong public value case. Also, there is a need to avoid reacting to immediate public pressure which can lead to kneejerk regulation which can have perverse effects and unintended consequences.

Self-regulation, based on values that are widely communicated, understood and lived, adapts more quickly to changing situations in a responsible way and can build commitment, pride and loyalty within a profession or industry. Of course, such an approach can be open to abuse. However there are ways to mitigate this, for example, making behaviours transparent through rankings or other ways to incentivise appropriate behaviour.

Much of the regulation to date has been focused on the outcomes rather than how the outcome is achieved. In the UK and the rest of Europe, the regulatory focus is increasingly shifting to culture and behaviour. This focus is important in terms of embedding long-term financial value. Cultures that are excessively short-term are not fertile ground for the kind of change we are advocating in this report.

For both regulatory and self-regulatory approaches, there is a need to ensure that they act in the public interest, and not just private interest, and have effective systems and processes of transparency and public accountability.

Moving towards the vision

Having set out our vision – how close are we to achieving it and what else could be done to move further towards it?

What is encouraging is that we are not at the start of the journey **– we are already on our way**.

There are numerous strands of debate and activity that are moving in the same direction.[10] However, they have yet to come together, in an integrated way to lay a solid foundation for the system to complete the next step in its evolution.

In this section we outline some of the initiatives already underway along with a number of interventions and areas for discussion and investigation that we believe could move the system further towards the vision. These have been categorised by the elements of the vision we have set out.

A wider view of value is adopted and reflected in the information provided to support decision making

A key driver of change is the recognition that a wider view of value needs to be embraced. One in which an integrated view of value, that is intergenerational, is adopted and takes into account economic, social and environmental factors, and is measured using both financial and non-financial indicators. Tomorrow's Company defines this new view of value as 'long-term financial value'. It gives a clearer line of sight on how to invest with the best interests of beneficiaries in mind.[11]

More and more CEOs and investors are recognising that by fully integrating a wider view of value into their strategy, business practices, products and services they are better equipped to drive future growth and value and to reduce risk. There is a growing constituency of investors who also see this approach as an opportunity for competitive advantage as a differentiator in determining industry leaders.

The simple fact is that both companies and investors have a common desire to understand what is valuable and material to the success of the business, capitalise on opportunities, ensure resilience to risk and earn a return. Yet, companies and investors are struggling to communicate effectively their shared views and both are frustrated at the speed of change. The causes of this disconnect are lack of a common language, not having the knowledge and skills to identify material issues and the lack of common measures and frameworks that fully integrate sustainability and traditional financial measures.[12]

Accelerate good practice in terms of accounting and disclosure for environmental and social impacts. Corporate accounting is already evolving to take into account social and natural capital and encourage a longer term view. This enables better mitigation of major risks and greater resource efficiency to gain competitive advantage:

- The Financial Reporting Council (FRC) has also confirmed proposals for boards to include a 'viability statement' in the strategic report to investors to provide an improved and broader assessment of long-term solvency and liquidity. It is expected that this statement will look forward significantly longer than 12 months.
- The establishment of Integrated Reporting (<IR>) provides a framework which encourages companies to think in a more integrated way about all the factors that materially affect their ability to create value and to communicate this more effectively.[13]
- In the US, the Sustainability Accounting Standards Board (SASB), an independent non-profit organisation, is working to develop and disseminate sustainability accounting standards that help public corporations disclose material, decision-useful information to investors.[14]

Those companies that are leading in enhancing and developing such accounting and disclosure practices, along with all others who wish to encourage and increase the scale of adoption of such practice, should be as active as possible in publicising, sharing and disseminating good practice examples.[15]

Raise the quality of research. Good investment solutions require good quality and comprehensive research. Investors and companies are also demanding integrity, transparency and accountability in research processes.[16]

Focusing on financial information only is too narrow and a wider view of value is essential. So called 'non-financial' factors are inseparable from financial factors. Issues such as quality of management and governance, people management, innovation, environmental sustainability all impact on financial performance, especially in the longer term.

There are undoubtedly benefits to the sell-side research. However, the problem is that the majority of this research is provided by investment banks with the numerous biases this creates.

Regulation to date has rightly focused on eliminating and controlling these biases as they push for greater transparency on the cost of research. For example, as part of MiFID II, regulations are soon to be introduced that will increase the transparency of payment for research and distinction between payments for research and trading. The exact impact of these reforms is still unknown. They may help increase the link between payment and quality, however they may also decrease the overall money paid for research.

However, less attention has been paid to how we can create well-funded, quality, independent third party research. This could be achieved through:

- Research houses/groups better reflecting the introduction of the FRC 'viability statement' by increasing the standard scope of research to include a 5 year or longer view, depending on the industry sector, as well as a 1 year view. This should also include comment on the quality of the profit and sustainability of performance.
- Investment managers, in advance of MiFID II, complying with existing Financial Conduct Authority (FCA) rules in considering how they identify and procure quality research that adds value to their investment decisions in the best interests of their clients. In particular, to take account of changes to the 'Use of dealing commission rules' issued by the FCA, and their Policy Statement 14/7 which noted that:

  "research focused on investor stewardship issues, such as the quality of corporate governance within a corporate issuer or looking at an issuer's strategic objectives and the sustainability of its business model, could be capable of meeting the criteria under COBS 11.6.5E. It remains for the investment manager to determine whether a given good or service meets the criteria for substantive research in each case." [17]
- Research houses/groups seeking to meet the certification criteria of ARISTA 3.0 which is about Accountability and is a Responsible Investment Research Standard comprising guidelines and rules, commitments and verifiable evidence of the transparency, quality, accountability and verifiability of the processes involved in Responsible Investing (RI) research.[18]

Encourage greater alignment between pension funds and their company sponsors. Pension scheme trustees are increasingly aware of the importance of aligning their investment strategy with the risks inherent in their exposure to their sponsor's business. They also need to ensure they are reflecting the views of their members who may also regard sustainability as important.

A barrier to achieving such alignment is lack of knowledge, so transparency between pension schemes and sponsors is important.

In order to create value for the long-term, companies are recognising that they need to revisit traditional business models. Success is increasingly dependent on building effective partnerships, internally and externally. The capital markets operate as networks of influences operating in different directions.

The members of a defined benefit (DB) pension scheme have a personal interest in the long-term success of the companies which support them and also on the impacts of the companies in which the scheme invests. They will end up living with the consequences of management's actions. So although the company and its pension scheme are separate entities they have a shared long-term interest.

The pensions' regulatory regime is evolving to recognise this. A few leading pension funds and sponsors are now working together to articulate their long-term objectives, investment beliefs and risk appetites. In some cases this is causing them to challenge current orthodoxies. For example, is progressive de-risking the best path for them? And where a scheme has a long-standing RI policy, can the improved resilience of the asset portfolio be reflected in the scheme's actuary's assumptions?

Further academic and professional work in this area would therefore be valuable.

Savings are channelled into investments which create wealth and secure well-being.

One of the key ways to support growth and well-being is to attract private, long-term capital to infrastructure projects. Although capital is available, barriers are making it hard for investors to channel funds into infrastructure projects, especially in early stage 'greenfield' projects. It would not be desirable for government to crowd out the private sector nor guarantee all risks thus reducing or negating any potential returns. However, government can assist by providing more certainty and line of sight on future projects and ensuring that other regulation does not cut across and impede potential institutional investment in this area.

Create a more conducive environment to encourage investments in infrastructure projects:

- The main risk for investors is political intervention delaying or diverting an infrastructure project. Creating an independent infrastructure commission focused on implementing projects, including resolving planning issues, in line with the country's infrastructure plan would help give certainty to investors.
- Risk-sharing between the public and private sector has the potential to improve investment conditions if done on commercial terms at arm's length from government, for example through providing subordinated debt on commercial terms.
- Ensuring that capital adequacy requirements for investors wishing to finance infrastructure fairly reflect the long-term risk around these investments and do not make it expensive to finance. For example, in the UK, the financial regulations that set out these capital adequacy requirements (IORP Directive for pensions and Solvency II for insurers) need to be revisited to ensure they fairly reflect risk and so are conducive to scaling infrastructure investment.

Scale up the activities of public banks. Across the globe questions are being asked about how public-private partnerships can best be deployed to close the infrastructure financing gap. There is a growing consensus that public banks will be key to building investor confidence through risk sharing with the private sector. China for example is establishing a $50bn Asian Infrastructure Investment Bank (AIIB), with support from the UK and other governments, to bridge the gap between the public and private sector.[19] It is expected to open in late 2015.

Recognising the infrastructure financing challenge is also one of deploying low carbon infrastructure, Jin Liqun, secretary general of the AIIB multilateral interim secretariat has announced the bank will be *"lean, clean and green"*.[20] In the UK there have been calls for the Green Investment Bank (GIB), which currently has £3.8bn under management, to scale up its operations through being allowed to borrow from the capital markets.[21] Given that 70% of the UK's national infrastructure needs are low carbon or low carbon enabling – with £100bn alone needed for energy infrastructure to 2020 – a bigger GIB would be able to co-invest at scale with pension funds on a risk-sharing basis or channel funds via the GIB into infrastructure projects that may otherwise be perceived as too risky to back.[22]

Seek out more opportunities for collaboration on infrastructure investments. In the UK the Pensions Infrastructure Platform is one vehicle but agreements to team up could be made directly between funds.[23] Perhaps Sovereign Wealth Funds (SWFs) could also invest in partnership with others such as private investors or pool with other SWFs?

Building awareness and encouraging individual choice. None of the potential remedies we have identified will have any lasting impact unless we, the individuals who invest our long-term savings, want change to happen.

To this end, we recommend that the investment community consider two short-term actions:

- ***Awareness:*** As the underlying investors in the system, individuals need to be given the information that helps them to understand how today's investment may impact the shape of the world tomorrow. We therefore propose that the investment industry, in the material it produces, underscores the link between investment and the world it creates.
- ***Walking the talk:*** Reflecting a value set or a vision of tomorrow in a portfolio is challenge enough for major pension funds. For individuals, exercising any genuine influence over their employer-sponsored pension pot or long-term savings plan is close to impossible. To start to address this, individuals need two things:
  - **Information**: How are their assets invested today? Knowledge of the long-term objectives and the current structure of their portfolio will help individuals to engage more constructively with those who manage assets on their behalf.
  - **Products**: Investors would benefit from a range of straightforward products that allow them to tilt their portfolios to more closely reflect their views on the opportunities that tomorrow's world affords.

This does not mean that individuals need to become asset managers, selecting their bespoke portfolios from the total universe of available stocks.

Instead, we encourage the investment industry to consider offering long-term savers a limited suite of products that would allow them to take a small step toward being able to tailor their portfolios. The ambition would be to allow those who wish to reduce their exposure to carbon, or who wish to 'sweeten' their portfolio with a little more renewable energy, to do so cost effectively.

Strong investment performance is pursued over the long term through a focus on stewardship, underpinned by collaboration and standards of integrity and transparency, and all the intermediaries in the system publicly declare the extent of their commitment to act in this way and explain how they fulfil these obligations.

Fiduciary duty provides a legal framework but stewardship is part of its application in practice. Side-by-side with those market participants that are very short-term focused are longer term institutional shareholders. It is their greater involvement and ability to exercise their power effectively that offers a way of rebalancing the system towards long-term financial value. A key element of this is how they hold boards to account – their 'stewardship' responsibilities as owners working with those who manage the company.[24]

In the UK, the primary focus on embedding stewardship has revolved around the UK Stewardship Code (the Code). First published in 2010, it is aimed at enhancing the quality of engagement between asset managers and companies to help improve long-term risk-adjusted returns to shareholders and operates on a 'comply or explain' basis.[25]

In support of the Code, The Pensions and Lifetime Savings Association (formerly the National Association of Pension Funds) has established a Stewardship Disclosure Framework to provide greater transparency around the stewardship policies and activities of those asset managers who are signatories to the UK Stewardship Code and therefore equip pension fund trustees with the information they require to better compare and contrast asset manager approaches to stewardship.[26] Levels of compliance to the Code are increasing year-on-year. The Investment Association (formerly the Investment Management Association (IMA)) undertake an annual survey looking at how institutional investors demonstrate adherence to the Stewardship Code and last year's report indicated positive change.[27]

But there is room for further improvement and a need to continue to encourage stewardship and a wider view of value in the investment decisions and offerings of all market participants. We set out below a range of possible ways to encourage this.

Create a stewardship ranking mechanism for asset owners and managers. Following the introduction of the UK Stewardship Code some asset owners are already using the Pensions and Lifetime Savings Association Stewardship Disclosure Framework for evaluation and comparison between the stewardship offerings of different asset managers.[28] The Principles for Responsible Investment (PRI) has also included relevant implementation indicators in its questionnaire for signatories. Building on these, the investment consulting industry, the asset management industry and asset owners could work together to develop a published 'stewardship ranking', but enhanced by stakeholder assessment based on actual engagement experience.[29]

Establish a stewardship accreditation in the wholesale market. Building on the above ranking mechanism, a form of stewardship accreditation could be developed for investment products. This could further encourage and recognise innovation in investor stewardship products.[30]

Develop a stewardship kitemark for the retail market. Once established, could the criteria developed for the wholesale market then, in time, form the basis for a stewardship 'kitemark' in the retail market either for particular retail products or investment houses?

Extend the scope of what is required to be reported by investment managers. There are calls for greater transparency and disclosure.[31] However concern remains about the extent to which investment managers apply the same level of transparency to themselves as they expect of the companies in which they invest. Those that are signatories to the UK Stewardship Code, are required to publish a statement that describes how they have applied the principles set out in the Code.[32] However, such statements give little insight into their actual practices. Should the Code require the publication of important institutional investor information on fund purpose, philosophy, investment guidelines and, most importantly, fund manager incentives and pay structure?[33] Statements on their stewardship activities and investment performance are required but these are not done in an integrated fashion – could the principles advocated by integrated reporting be applied?[34]

Stop stock lending for fiduciaries and those who aspire to be good stewards. The main reasons for lending stock are to gain additional income and improve market liquidity. However, there is a potential for misuse, such as the voting rights being exercised by those who have no long-term interest in the company. There is an existing code of best practice issued by the International Corporate Governance Network (ICGN).[35] Some pension funds are already avoiding stock lending such as the Essex Pension Fund, with £4.3 billion of assets, and Nottinghamshire County Council, the fourteenth largest fund, which has said that the practice ran contrary to its statement of investment principles.[36] Pension fund trustees are long-term owners and have a fiduciary duty. Should they not consider and review periodically whether it is appropriate that they lend stock? The same applies to other signatories of the Code.

Improve dialogue between investors and companies through the Investor Forum. This was established in the UK to make the case for long-term investment approaches and to create an effective model for collective engagement with UK companies. The forum should help facilitate more productive conversations between investors and public companies and leave less room for companies to dismiss individual investors' concerns as 'one-off'.[37]

Statutory bodies and government pension funds should continue to increase their influence as long-term owners through their SIPs, mandates, voting and engagement. Examples of such bodies in the UK include the Pension Protection Fund (PPF), National Employment Savings Trust (NEST), Environment Agency Pension Fund (EAPF), local government pension funds. Could greater collaboration between these bodies be achieved? SWFs, national social security funds and state shareholding vehicles are in a strong position to exercise stewardship influence on behalf of their beneficiaries and often have a mandate to 'benefit future generations'.

Continue to seek out more opportunities for collaboration on voting and engagement. Engagement is increasing and is making an impact on corporate behaviour.[38] This can continue to be strengthened through combining shareholder power, pooling resources to research issues, sharing objectives either on single issues or set of issues and engaging with the companies and/or drafting shareholder resolutions for AGMs.[39] Sector specific collaborations should be considered such as across local authorities, charities, trade unions etc.

Enable consolidation or multi-fund management for smaller pension funds. Many smaller pension funds lack the resources and skills to fulfil their fiduciary effectively. In part this can be addressed through scale which will increase resources and expertise. Can legislation be put in place that will enable consolidation/multi-fund management without breach of fiduciary duty and tax laws be changed to promote such consolidation?

Long-term value creation is reinforced through aligning skills and linking targets and incentives to the needs of clients and beneficiaries.

In the first report of the Tomorrow's Capital Markets programme, a number of principles for incentives were set out. The first of these was the need to ensure that incentives take into account and are aligned to the needs and wishes of both today's direct beneficiaries and future generations who will be affected by business decisions made today.

There is a growing appreciation that success should be measured in ways other than just financial performance and this is starting to flow into the mind-set, skills and how incentives are structured. There has also been considerable attention paid to the structure of financial incentives by regulators and policy makers.

However there are cases where it is questionable as to what degree the needs of the beneficiary are prioritised and whether there is alignment in the outcomes being sought across the chain serving that beneficiary.

Transparency is a key element in achieving greater alignment. It leads to better accountability and enables effective comparison of products and services. Some key areas to address are highlighted below.

Removing conflicts of interest. Much has been done to remove conflicts of interest from the system. However there are two areas which warrant further consideration.

- ***Advisors:*** There are still situations where the same firm or individual may have a potential conflict of interest in terms of giving advice as well as providing products. For example, tied sales forces or where consultants recommend their implemented consulting product to pension fund trustees whom they represent.

  In all these cases, the potential conflict should be made clear to the customer/client as well as what steps are taken to ensure their interests are protected. In the investment consultancy, should it be a requirement that the two services (investment management and advisory) are provided by separate legal entities? Should the underlying fees always be separate?

- ***Asset owners supporting share based compensation:*** Where asset owners vote for compensation packages that are heavily based on stock options, short-term performance objectives or overgeared they are effectively voting against the interests of their beneficiaries.

  Such packages can lead executives to focus on fast growth to manage the short-term expectations of market participants, not on the underlying fundamental performance of the company.

  So should asset owners stop voting for these packages and encourage alternatives such as cash or straightforward long-term shareholding?[40]

  Whatever package is used, above all the design should be simple and not have overly complex criteria. It needs to be meaningful to the people whose behaviour it is designed to influence.[41]

All costs, remuneration structures and principles including time horizons should be made transparent to asset owners. Fees and compensation affect investment returns and are interconnected. There is growing pressure to improve fee transparency across all investments.[42]

However there is less pressure to disclose the amount of remuneration that an intermediary receives, the principles on which this is structured and the origin. Such details may illuminate any misalignment of interests and/or impact on returns.[43]

Complete transparency may not be appropriate for compensation but what is stopping an enhanced level of information being provided to the client?

Contrary to popular belief, full remuneration disclosure may also have benefits within the organisation.[44] Provided the processes and criteria are clear and perceived as fair, it can help foster a meritocracy, places greater pressure on companies to impose pay equality and remove suspicions of unfairness in remuneration among employees. It may also help slow any widening gap between the highest and lowest earners.[45]

Improve the governance of pension funds. Striking the right balance between diversity of experience and opinion on the one hand and relevant industry knowledge on the other is important in any board structure. A number of trends are acting to reduce such diversity on trustee boards, not least because the pipeline of lay and member-nominated trustees is shrinking as more responsibility and greater expertise is demanded of the role. Many funds are appointing delegated consultants or fiduciary managers, raising issues around conflicts of interest and corporate governance. All these changes are increasing demand for independent or professional trustees.

Given these trends, how will diversity be maintained? How can tenure be managed bearing in mind the need to retain experience against the need to refresh the board?

One way might be for independent trustees and professional trustee firms to align tenure with corporate governance norms (hence a maximum of 9 years) and for a firm's collective blend of experience to be considered as part of the selection criteria? Should there be more active succession planning for diversity?

The scale and activity of what some refer to as the 'casino' economy does not pose a threat to the operation of the 'real' economy, while recognising the need for sufficient, but not excessive, trading to enable the real economy to operate effectively.

There is an ancient way to differentiate value going all the way back to Aristotle. He distinguishes between 'value in use', which is dependent on the demand for an item as a function of its utility as a product, and the concept of 'value in exchange' which applies to money and some commodities (as well as to equities and bonds) insofar as they can be traded and can transfer ownership or access rights between counterparties in a secure way. Some commodities fall into both categories as they are both a medium of exchange and have physical value in use (metals, gems, and some soft commodities).[46]

Aristotle argued against the use of something purely to profit from its exchange value, or effectively against the use of money to make money. Much has changed since he made this distinction. Today one might expect him to acknowledge that there is an appropriate balance between long-term investment and the need for liquidity.

There will always be a diversity of investment styles. There will always be some who wish to speculate rather than invest. Recently, however, speculative trading methods have become particularly troubling because they are believed to undermine trust in markets and as a consequence may have an adverse effect on liquidity and market efficiency. The two aspects of speculative trading that have raised concern are:

- ***funds with long-term mandates acting like short-term traders:*** indicators of such a breach of mandate included very high portfolio turnover – turnover that often increases as performance starts to lag behind benchmarks. There needs to be sufficient transparency about portfolio activity to allow investors and trustees to assess whether a long-term mandate is being pursued by the managers. If not, there needs to be a willingness to hold managers to account
- ***high frequency trading** (HFT)**:*** this is an umbrella term that encompasses a variety of activities. At its worst, HFT is associated with 'rigging the casino' – having an edge over the trading of others. This distorts the markets, reducing confidence and creating illiquidity. This is a huge topic that warrants its own study. However restricting the speed of access of HFT traders to the market could have a significant short-term benefit.

Other suggestions raised to curb the 'casino' included the possibility of introducing a 'financial transaction tax' or similar. Here the debate remains highly polarised.[47] Some countries have already adopted such an approach and some countries within the EU are currently actively progressing such a move. Should such a tax be global in its application? How can productive trades and unproductive trades be distinguished? Could there be a cap on the number of trades made that are free? How can the proceeds of the tax be funnelled towards long-term productive outcomes?

Future indicators of success

So far we have set out our vision; some of what is already moving the system towards it and our proposals for further change.

In this section, we consider what the key performance indicators (KPIs) for key participants in the system might look like if the vision had been achieved.

These suggested KPIs are not comprehensive and in presenting them for discussion and development we recognise that some of the necessary metrics are not yet available.

However, we believe we should not limit our thinking to only those KPIs that can currently be easily measured or measured with great accuracy. There is a danger of false precision. As the sociologist William Bruce Cameron put it: *"Not everything that can be counted counts, and not everything that counts can be counted."* [48]

Metrics are often used because they are easy to use rather than being the right metrics. Many metrics seem right and are easy to measure, but have unintended consequences. Other metrics are more difficult to measure, but do focus on those decisions and actions that are critical to success. Precise metrics are desirable but well considered proxies may need to be used.

Key performance indicators

For all participants

- How well the value created and accompanying risks are assessed and reported in an integrated way using frameworks such as Integrated Reporting.
- The codes, certifications, principles, and standards adopted are stated along with how they have been improved upon year-to-year (e.g. PRI, UK Stewardship Code, Global Compact, Equator Principles, Montreal Carbon Pledge and/or the Portfolio Decarbonization Coalition, OECD Guidelines for Multinational Enterprises, International Labour Organisation Declaration on Fundamental Principles and Rights at Work).
- The degree to which performance is assessed and rewarded in a way that embeds behaviour in line with the stated values of the organisation, codes of conduct and client and end beneficiary satisfaction.
- All benefits accrued through the scale of client funds are tracked and passed on to the clients.
- All information about fees, costs and remuneration is provided to the client in a clear and simple manner.

Asset owners

- Degree to which all SIPs and mandates state what their 'view of value' is and how they expect this to be followed through in practice.
- The percentage of the portfolio allocated to long-term investment vehicles which create a financial return through delivering a social or environmental benefit.
- For DC schemes – levels of engagement, education and assistance to members in decision making.

Asset managers

- Degree to which the mandate's view of value has been rigorously followed through in practice.
- Degree to which principles for engagement adopted and summaries of matters raised in engagements, voting policy and votes on resolutions with companies are publicly reported.
- Ranking achieved on quality of stewardship engagement and on ESG ratings scale.
- Degree to which number and quality of impact economic, environmental and social assessments completed for investments and criteria used are publicly reported.

Analysts

- The degree of collaboration in undertaking research, time frames over one year and inclusion of material and intangible long-term risks.

Investment consultants

- How proactive, timely and accurate their advice is and the quality of their interaction with the client.
- How clearly they explain the options open to their clients within their fiduciary obligations, and how they encourage clients to consider quality of stewardship as a constituent part of long-term investment performance.
- Percentage of funds passed to third parties versus placed in-house (where applicable).

Next steps

Over the past twenty years Tomorrow's Company has been reasserting the human purposes of business. The evidence is clearer than ever. Companies which embody those human purposes have done a far better job for shareholders (and for society) than those which focus exclusively on financial gain and short-term shareholder value. Some CEOs may do well out of the single-minded pursuit of short-term results, as may a few well informed shareholders. But it is in the interests of us all – as shareholders, employees, citizens and consumers – that the capital markets are set up in ways that align their operation and rewards with the encouragement of sustainable companies whose profitability and growth is sought through the creation of long-term value.

The world changes ever faster. And in fact during the same twenty years, the evidence has started to accumulate about the risks to our investments that lie in the narrow pursuit of value as it has traditionally been defined by economists and investment bankers and too many investment managers. In the years ahead, the definition of value used by investors and capital markets will inevitably change further as the evidence accumulates of the strains being placed on our planet.

The subjects being tackled in this report are complex, and it is impossible to reach a detailed set of recommendations for action while conditions constantly change. This is why we have chosen to pose a series of challenges and identify the levers for change that can build on existing momentum to shift the system. This is the context in which we will take forward the vision and the challenges contained in this report. We envisage, among other things, the following opportunities:

Leadership

We are challenging leaders, especially in capital markets and financial services, to reflect on what leadership will involve in the future. Is being a leader within the rules of the current system enough or does inspirational leadership mean working with others to reshape the system? How can current leaders create the opportunities to be challenged on these issues, particularly by the generation, now in their twenties?

Governance and Stewardship

Governance and stewardship go hand in hand. Governance, like exercise, is a discipline for ensuring that the body corporate is fit and productive. Tomorrow's Company's work on governance, through the Good Governance Forum established in 2010, is focused on exploring what good governance means, making practical recommendations to boards and policymakers and creating guides and tools for companies. Our approach transcends compliance and focuses on purpose, values, innovation and entrepreneurial activity. We define stewardship as *"the active and responsible management of entrusted resources now and in the longer term, so as to hand them on in better condition."* We need an approach to the ownership of shares in a company which goes beyond traditional habits and assumptions and ensures that those who lead it feel accountable to a body of shareholders that is committed to that company's long-term success. Stewardship is therefore a joint responsibility between the company's board and its owners. Our focus now is to strengthen the golden thread of stewardship by developing a shared agenda between asset owners, asset managers and companies. Through our developing partnership with Stewardship Asia and other likeminded organisations, our work on stewardship has growing international impact. In the UK it has led to the development of four principles of stewardship, and to the success of the 2020 Stewardship Working Party on whose recommendations we continue to build. We will continue to take forward these agendas for change on a collaborative basis.

Overall, we will continue to engage professional bodies, other key networks, regulators, policy makers and opinion leaders and build on the desire and momentum for change that we have identified in this report.

Perspectives

Damian Carnell
Director,
Towers Watson

The impact of incentives – be careful what you wish for

Fire is a good thing: for example it helps us keep warm in the winter, cook our food and gives us energy for hot water. But uncontrolled fire is a very bad thing: it destroys life and property, sometimes on a vast scale.

Incentives are a good thing too – but like fire there can be a dark side if they are not designed well or if they are not controlled properly. Good incentives have a vital role in modern capitalism and the creation of wealth, but bad incentives lead to dysfunctional outcomes, and in 2008, they arguably contributed to the near-collapse of the whole global financial structure.

Incentives are very powerful. They not only provide an 'in flight' effect for executives to aim to attain high reward, but more importantly they communicate the values and direction of the employer more clearly to the executive than any other form of communication. Incentives endorse the behaviours that are expected of executives, and those behaviours will almost always follow. Be careful what you wish for, as they say.

Sensible corporate responsibility and good culture will mean good incentives are deployed. Conversely, poor responsibility and culture mean often excessively risky and poorly designed incentives will be unleashed.

The incentive design process is vital. A well debated incentive structure reflecting the business model, future prospect, risk appetite, and need to compete for and reward key talent are all important. When this debate is informed by strong culture, sensible risk awareness and good corporate governance, good incentives tend to be the result. When it is not, poor incentives can arise, and as a result poor outcomes, even disastrous ones, can follow.

So, should incentives be hobbled by regulation or even banned? Most likely not, as there is too much to lose if a draconian approach is taken. But in future there needs to be a much greater awareness of the design process, the importance of governance in design and operation, and the role of good corporate culture for incentives to be improved.

Going forward regulators and governments might wish to think more deeply about this wider context if significant improvement in incentive design is to be seen in practice.

What can we learn from systems theory?

Mike Clark
Director, responsible investment,
Russell Investments

Following the global financial crisis, many of us felt that the system had come close to failing. This got me wondering about how we should think about a system. How should we think about the participants in the system and their interactions? How do systems evolve? And I found there was such a thing as systems theory, born it would seem as a development of engineering science. Engineers do systems. I had also been looking for a framework to embrace all the interventions we were seeing in the financial system: the Kay Review, the Stewardship Code, UNPRI, the Climate Bonds Initiative, Integrated Reporting, and more. One particularly helpful strand of systems theory that I found is the idea of a hierarchy of interventions in a system, as advocated by Donella Meadows. This sets out a 12-point hierarchy of interventions.[49] Now, some interventions are relatively easy to make, but tend to have little effect. Others are more powerful, but harder to achieve.

So how do we apply this to the financial system, or at least the long-term savings/ investment/capital part?

Firstly, we need to recognise the four leading participants: citizen savers (e.g. pension fund beneficiaries), asset owners, investment managers and companies (or other issuers of securities). These four participants 'own' the investments in the system. And there is a fifth participant – policymakers. Next, we look at a particular intervention and determine where it sits in the hierarchy. For example, the UK Stewardship Code arose from regulation (level 5: Rules) and led – indeed, is still leading – to greater flows of information about share ownership. And when the industry decided that more was needed, self-organisation (level 4) delivered the Pensions and Lifetime Savings Association Stewardship Disclosure Framework. Let's take another example. Nearly 10 years ago, a group of asset owners established the United Nations Principles for Responsible Investment – self-organisation, again. That encouraged and supported a lot more transparency about the integration of ESG factors into investment decision-making. Higher, more powerful, interventions tend to give rise to further interventions further down the hierarchy.

What might we learn from this way of thinking? Quite a bit. We can recognise the power of self-organisation, of participants getting together to change things. This activity can be more powerful than the rule-making aspects of a system. That seems to make sense, since participants agreeing to certain actions may well be more effective than rules forbidding certain activity. In the finance sector in particular, we could say that good regulation seeks to encourage good behaviour, whilst some regulation which seeks to forbid certain types of behaviour may be less than effective. The first goes with the grain, the second approach can simply lead to attempts to circumnavigate the rules.

Near the top of the hierarchy, we find 'paradigms'. How do we think about the system, and its goals? A narrow view of the long-term financial system will tend to focus on risk and return, and the investment industry's tools of alpha, beta, CAPM, tracking error, and the like. But is this enough? Adam Smith talked about capital, labour and land. We seem to spend a lot of our time on the first. Or, as John Kay famously recommended in the Kay Review, *"the metrics and models in asset management are not fit for purpose"*. Perhaps the creation of wealth, its distribution, and the meaning of value need greater emphasis.

In order of effectiveness:

1. Beyond Paradigms: Transcending paradigms
2. Paradigm: Mind-set out of which system (goals, structures, rules etc.) arises
3. Goals: Purpose of the system
4. Self-Organisation: Power to add, change, evolve system structures
5. Rules: Incentives, punishments, constraints
6. Information Flows: Structure of who does and who does not have access to information
7. Re-inforcing Feedback: The strength of the gain of driving loops
8. Balancing Feedback: The strength of the feedbacks relative to the impacts they are trying to correct
9. Delays: The lengths of time relative to the rates of system changes
10. Stock & Flow Structures: Physical systems and their nodes of intersection
11. Buffers: The sizes of stabilising stocks relative to their flows
12. Numbers: Constants and parameters e.g. subsidies, taxes, standards

Donald Fleming
Managing director,
pensions advisory,
Gazelle Corporate
Finance

The capital markets as a neural network – should pension funds align with companies?

A core function of the capital markets is to create and allocate capital efficiently, both across society and over time. But this is not a linear process and what this project has identified is that it operates in a sense like a neural network, with the actions of each player affecting its neighbour, with knock-on effects over time through the system.

Conflicting incentives and misalignments of interest distort the strength of these effects across the capital markets. Conflicts of interest between different players in the capital markets rightly receive attention, but one of the important outcomes of this project has been the attention it has paid to calibrating *alignments* of interest – and rightly so, for this is where careful calibration of incentives can promote value.

We see this calibration across the system, an important example being that between ownership and control: when founders or generations of founding families exercise control of a company (say through dual voting rights shares) despite only owning a relatively small proportion of the company's share capital, there is a risk that they will favour their own interests over those of external minority shareholders. Nonetheless such companies are attractive to many investors precisely because they see an alignment of interests in sharing economically in a founder's vision for the company or a managerial approach taken over several generations. So, in practice, governance and disclosure mechanisms are used to address the type of conflicts of interest and calibrate alignment of economic interests arising here through equity capital.

Capital flows in different directions. Many large companies not only support pension schemes but are owned, ultimately, by pension schemes. The relationship between companies and their defined benefit pension schemes is an important example of the need to re-calibrate the balance of incentives.

The pensions regulatory regime has been built around the conflicting interests between a company and its pension scheme(s), with the scheme positioned as a quasi-creditor of its sponsor, limited in its ability to invest in it and with a separate governance structure.

However, although pension schemes are in one sense competing with their company's shareholders for funding, they fundamentally depend on the long-term health and cash flows generated by the company. So in the wider sense there is an alignment of interests. This is now being recognised. Two regulatory developments stand out: the introduction of a new statutory objective to take into account the 'sustainable growth' of the sponsor, and the shift of pensions regulatory emphasis on collaboration and integrated risk assessment.

A few leading pension funds and sponsors are now working together to articulate their long-term objectives, investment beliefs and risk appetites, building on this shift of regulatory emphasis. In some cases this is causing them to challenge the current orthodoxy that pension schemes with very long liabilities, even those supported by very strong sponsors, should inevitably be on a de-risking path. This is to the good, for long-term value creation ultimately needs an equity risk culture. Nonetheless, this will require a shift in the professional consensus of opinion within the consulting industry. Further academic and professional work in this area would therefore be valuable.

“The more we invest with foresight; the less we will regret in hindsight” Mark Carney

Mark Goyder
Founder and chief executive, Tomorrow’s Company

At the time I am writing this, the UN’s humanitarian budget deficit is in the news. When compared with the financial scale of the capital markets, the numbers seemed trivial. The entire UN humanitarian budget is less than the record profits made by one company – Apple – in 2014.

As well as being an act of mercy, humanitarian aid is an investment of a sort. Fail to invest, and people starve and die. Migration pressures intensify; cities cease to function; potentially fruitful lives are held back or snuffed out. As this report shows, there are other human aspects of our economy where the failure to invest with the needs of our grandchildren in mind has more immediate economic consequences. The $83bn just to feed a growing world population. The 1bn people lacking access to fresh water. There are many examples to show that if we invest imaginatively, new technologies and new possibilities emerge. Elon Musk’s solar battery lessens domestic dependence on the grid. Similar breakthroughs have removed the need for Indian villagers to use unhealthy and dangerous kerosene stoves. The ability to lend and transfer money on mobile phones has opened up the economy and empowered women across rural Africa.

All these economic benefits are the stuff of capital markets. We need capital markets, like companies to be a force for good. We need them to be the servants of society and not behave like the masters of the universe. They are stewards of our savings.

What’s getting in the way? First there’s too narrow a view of value, clothed in an outdated and inaccurate understanding of fiduciary duty. It was the late Sir Adrian Cadbury, Quaker business leader and pioneer of better corporate governance, who said 25 years ago *“Of course I want a good pension when I retire, but I also want to retire into a world where I can enjoy my pension, breathe clean air, and enjoy good health”*. In the UK the Law Commission has made it clear that pension trustees are not bound to seek the highest financial return, irrespective of the investment, and are able to exercise their own judgement about value provided that there is not a clear financial detriment.

The second big obstacle is the complexity of the chain that links the saver to the end use of the money she or he invests. If savers are to invest with the ‘triple context’ of future environmental, social and economic wellbeing in mind, then things need to be simplified, and perhaps localised. Is it so impossible that a mere 10% of all the pensions saved by public employees in the North East or South West of England might be invested in infrastructure and preventive health care in the region? How long will it take before the first private sector retail stewardship fund opens up which promises to achieve at least market-matching returns from long-term investments in the index with leading edge stewardship practices fitted as standard?

Entrepreneurs and the companies that they create lie at the heart of sustainable wealth creation. Around them we need all the other components of a successful and civilised economy. The rule of law. Stable government. Both of these underpinning efficient markets. Those markets in turn depend on and supply other needed elements of a civilised society. Strong education and training; decent nutrition and health care; sustainable supplies of energy. And, crucially, the ability of a population of nine billion people to live within the capacity and limits of one planet, not one and a half heading beyond two as is currently the case.

As historians look back at our struggles globally to meet these needs, the thing they will notice most of all is the compartmentalisation of our efforts. Those who work in and around our capital markets are every bit as important to our tackling these vital human needs as those who work in health, social care and education. We need to design the rules of markets and shape our habits as market participants so that we see life this way. Working in partnership with many other groups, that is what I hope the contribution of Tomorrow’s Company will be.

Funding long-term research

Roger Hirst
Director of engagement, Hermes EOS, Hermes Investment Management

Leon Kamhi
Head of responsibility, Hermes Investment Management

Sell-side research in some ways is a paradox. There is too much of it and at the same time it seems to provide too little long-term insight. It is often overly focused on quarterly trends, results versus consensus, or the near-term implications of the latest piece of information. There is an abundance of this short-term and sometimes shallow analysis; many companies are covered by over 30 sell-side analysts, and as a result fund managers receive 30 or more versions of quite similar research. This in our view contributes to the current damaging short-term focus in capital markets. Long-term investors complain about a shortage of in-depth research, and yet it is hard to see how the trading houses can be incentivised to produce more strategic analysis so long as the current payment structure prevails. For long-term investors and the clients they serve, reforming how research is paid for is a key step in encouraging a longer-term approach across capital markets.

Part of the problem is that producing in-depth research requires significant investment from the sell-side. A team with the experience to analyse strategies and trends is expensive and takes time to build. As research department budgets have been squeezed since the financial crisis, the focus has increasingly come to be on short-term research.

Furthermore, a key driver for the production of short over long-term research is that sell-side research is being predominantly paid for out of trading commissions. The high-turn-over client pays, and gets what they pay for. In contrast long-term investors trade less frequently and therefore have a smaller flow from which to pay for research. The trading houses see the flow, and independent research providers who aim to offer more in-depth research struggle to compete.

The long-only funds could pay for research directly. Encouragingly, there is evidence that long-term investors see value in more in-depth research. However, paying for it would involve increasing management fees, as they do not generate the proportionate commission flows. This raises an obvious competitive problem: so long as high-volume traders, such as hedge funds, can pay for their research out of the fund via commission, the long-only funds look expensive.

A possible solution would be to legislate to de-link the payment of research from trading, instead paying for all research out of fund management fees. Fees would consequently rise, though the net cost to the investor should be neutral as commissions charged to the fund would decline – assuming the total cost of research remains the same, although of course we may anticipate a decline in volume or ‘noise’. Research would no longer be paid for by, and serve, the funds that trade the most, but instead those with the greatest funds under management, including the longer-term investors.

The current EU directive implementing MiFID II could help move the market in this direction. The regulations will create greater separation between execution and research commissions, as well as increase transparency. If this helps make investors more discerning, it may improve the link between payment and quality and encourage more in-depth and differentiated research. However history shows that reforming sell-side research is fraught with difficulty, reforms often being neutered by strong vested interests. We will have to wait and see if the new regulations move us a step forwards. Either way, this is one step in a journey that has much further to go.

Funding solutions needs an active approach

George Latham
Managing partner and CIO, WHEB Listed Equity

This valuable paper from Tomorrows Company is focussed on the need to find ways to incentivise capital to be deployed in such a way that it better supports the long-term needs of society and future generations.

There is a strong link and an overlap between this discussion about how to mobilise more capital to play an active role in creating more positive economic outcomes, and the debate about the potential for stranded assets in the traditional fossil fuels sector and the consequent need for portfolio decarbonisation.

One area that the paper doesn't stray into is the wider tension in the investment world between active and passive investment strategies. Traditionally that debate has focussed on cost and the ability of active managers to beat a benchmark. However, the one thing we know with certainty about the future is that it must be radically different from the past.

The imperatives of resource depletion, climate change and ageing societies demand a significant reshaping of industrial activity. Traditional benchmarks are backwards-looking and cannot accommodate this future orientation. One of the key conclusions of Mercer's 2015 report *Investing in a time of climate change* was that the expected impact of climate change on future investment returns at an industry sector level would be even greater than the impact on returns between asset classes.[50]

Equally, low carbon indexes which screen out fossil fuel exposure do little to create additional investment in the low carbon economy. It could even be argued that such an approach creates worse outcomes, as the divestment from fossil fuel companies by 'stewardship' investors without at least an equivalent reinvestment in solutions, simply results in the increased ownership of fossil fuel sectors by less responsible investors. What is needed is the diversion of capital to better uses and building a new economy…this needs active choices and capital allocation.

To do this requires a focus on the impact of investment decisions, within a framework which considers risk, return and impact in a mutually reinforcing and self-sustaining combination.

During the 19th century investors targeted returns in isolation, and in the 20th century the finance industry sought to balance risk and returns. The events of the first decade of the 21st century have shown this approach to be overly short-term with adverse impacts. What is required today is for investor focus to integrate risk, returns and impact.

Malcolm Preston
Global leader, sustainability & climate change, PwC

Tim Wright
Financial services pay, performance & risk partner, PwC

Measuring and managing corporate impact on society

Creating the right incentive model for a globally sustainable capital markets system is difficult enough but how can stakeholders really be sure that what is being incentivised is right? Business today is suffering from a global trust deficit and recent experience has underlined time and time again how fragile trust can be together with how serious the consequences are when it evaporates. But how do businesses practically go about rebuilding that trust?

Well managed companies do great things. They create jobs, drive activity and growth, generate profits, fund tax revenues and fuel global trade but all too often are perceived as ruthlessly pursuing their own agenda with no thought for societal impact. In order to regain trust businesses need to define their purpose in society clearly and explicitly take into account the needs of all stakeholders. By doing so society can gain an unimpeded view of why businesses exist, what they do and why.

But just having a purpose isn't enough. Every business needs to find a way of measuring and articulating its impact in a multidimensional way. Why? Because financial measures are no longer enough. While numbers are still important a myriad of other factors have a bearing on how a company is perceived by investors and by the wider world.

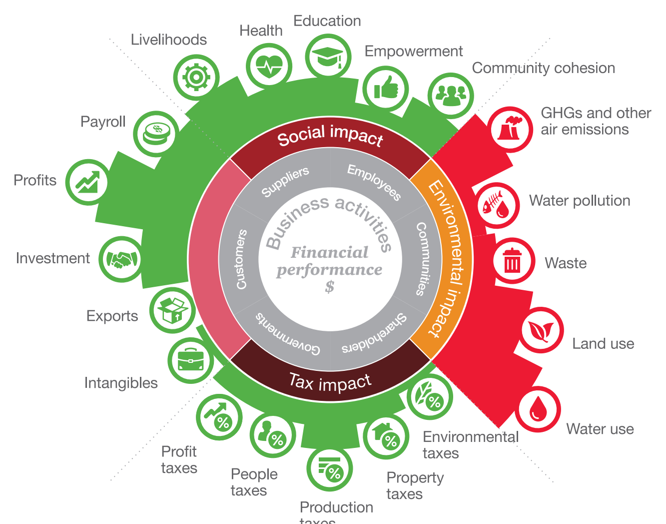
Companies have raised their game in social and environmental reporting however as this continues to evolve, today's assurance model, grounded in financials, is lagging behind. What's needed is a new model – one that enables a business to provide transparent, credible and integrated insight into the impact it has. Simply put, a company should be able to show whether it's growth is 'good' growth in line with its purpose and therefore worthy of trust.

PwC has been working with clients for the past few years to create the basis for such a model to measure, manage and track the different ways that business has impact. We call this Total Impact Measurement and Management (TIMM).

TIMM separates out organisational impact into four core domains and then further into sub-categories, assessing specific impacts under each. In doing so TIMM enables management to develop a better understanding of the social, fiscal, environmental and economic impacts of their activities. It can also be used to compare different strategies and investment choices. It will open the way to new and wider approaches to assurance by enabling companies to source information and the processes used to assure allowing the reader to decide for themselves how credible and trustworthy that information is.

At PwC we believe this is a good start on the journey to providing transparent and credible insights into a company's impacts that will ultimately drive renewed trust but there is a long way to go. The entrenched focus on financial statements and on short-term performance and planning over sustainability will be tough to break.

PwC Total Impact Measurement & Management framework (example)



"We need to find a fair, transparent means of encouraging managers to properly implement the (UK Stewardship) Code. One option we have considered is to delist those who fail to update their statement annually – admittedly a drastic solution…We don't believe that owners should be compelled to adopt any one particular approach to stewardship – if it's forced on them, it will only create more work for advisers and intermediaries. But it's all very well that we hand down admonitions to managers to be responsive to client's demands; nothing will change in practice unless clients really do demand evidence and explanations. Owners must put managers under the spotlight. And if our principle-based system is found wanting, then we will only have ourselves to blame if European legislation takes its place."
Sir Winfried Bischoff, chairman, Financial Reporting Council.[51]

"Objective, primary research using the enhanced analytical lens of Environmental, Social and Governance (ESG) imperatives is essential to the future of finance and capitalism. This kind of investment research will lead to greater predictive insight into the economic and profit outcomes for the world's private sector. Corporate strategic planning can also benefit from these insights, if companies recognise the importance of their financial and non-financial stakeholders to value creation. Cornerstone has developed two tools in the context of a proprietary framework for progress: The Shareholder Alignment Frontier™ and the BRAVE Matrix™ (Business Relationship Analytics for Value Creation). The intent is to help companies optimise stakeholder relationships and align their strategic assumptions with the perspectives of shareholders. If we strive to achieve the aspirations of the new UN Sustainable Development Goals (SDGs), then we need the private sector to reach for the new frontiers of capitalism…aligning profit with purpose."
Erika Karp, chief executive officer, Cornerstone Capital Group

"We at The Unipart Group recognise the shared and widespread concern surrounding present-day capital markets and we therefore welcome this report and the issues it raises wholeheartedly. We have learned throughout our own transformational journey that to truly change a global business' culture, we need to systematically engage our people at all levels to embrace a sustainable way of working with a strong customer focus and responsible values at the core. This same commitment applies to the financial system. The only way to strengthen the stability of global financial markets (without excessive regulation) is to galvanise cultural and behavioural change from within – suitably encouraging behaviours which result in sustainable, prosperous and equitable outcomes. As signatories to this report, we are committed to doing all we can to apply these ideas internally and with our clients."
John Neill, chairman and group chief executive, Unipart Group

"In a world where good governance can no longer be presumed as professional behaviour, Pension Scheme Trustees and significantly, the members they represent, must seek to more directly express their responsibilities of capital ownership. Realisation of this ambition however demands practical means of so doing, such as the Red Lines initiative from the AMNT."
Barry Parr, founding co-chair of the Association for Member Nominated Trustees (AMNT)

"In addressing the problem of capital market short-termism we are relying on stewardship by a handful of UK insurance companies and pension funds that own a small and decreasing proportion of the UK equity market. So a big challenge for the future will be to induce foreign institutional investors who are now the majority owners of the UK quoted corporate sector to engage constructively with UK company boards. The difficulty is that the business models of many fund managers, both foreign and domestic, give them no incentive to engage with company managements. There is also a more general question about the competence of fund managers to monitor corporate performance and engage in strategic dialogue."

John Plender, columnist and contributing editor, Financial Times

"It doesn't take a great deal of digging to see that some managers are more committed to the stewardship code than others. This makes it very difficult for a scheme to try to compare and contrast different approaches to award mandates to those doing well."

Will Pomroy, policy lead: stewardship and corporate governance, Pensions and Lifetime Savings Association

"Across the world, we are seeing a 'quiet revolution' in how the financial system can help deliver long-term sustainable development. For China, the driver is mobilising the USD400bn a year that's needed to build its new eco-civilisation. In South Africa, pension law has been clarified to make clear that sustainability now forms part of prudent investing. In each case, the mix between societal expectation, market innovation and policy direction is different. The UK has evolved its own distinctive approach to sustainable value creation, with the Bank of England now playing a new role in exploring the systemic implications of climate risk. Much has been achieved, but much more still needs to be done to turn good into customary practice."

Nick Robins, co-director, Inquiry into the Design of a Sustainable Financial System at UNEP

"There is too much separation between so called financial and non-financial factors. If you believe companies will have better future returns if they are well-managed with good social and environmental policies then why are these 'extra financial' factors? If you are considering carbon because there is some downside risk which may or may not happen, then why is that 'extra financial'? Should the risk be realised then the impact will likely be financial. The separation of financial and non-financial factors in the language we use is unhelpful. They are all factors that may affect your future performance albeit the impacts might be realised over different time periods. We also use the term ESG – for starters, good governance should always be desirable but, put the G together with the E and S, overlaid with a view on fiduciary duty and this often translates to 'We just can't invest in that'."

Mark Walker, global CIO, Univest Company, Unilever

Breaking the mould in the fund management industry…

There are welcome moves towards greater alignment between the interests of fund managers and their investors. Some examples are:

Orbis Access is an online retail investment service launched in January 2015. The funds offered by Orbis Access have a structure where fees are entirely based on performance. They only start charging a fee once the fund's returns exceed those of its benchmark. Half of any outperformance on the investment over the benchmark is taken as a fee. But equally, half of any underperformance in relation to the benchmark is repaid in the form of a refund. Normally the fee goes from the fund to the fund manager. But with Orbis Access the fee flows into a pot called 'The Reserve'. Some of the fee money in 'The Reserve' goes to the firm – a maximum of one third of it every year – but most of it stays in there, to potentially be used as refunds in the future.[52]

Woodford Patient Capital Trust was listed on the stock market in April 2015. The trust has an unusual charging structure. Woodford Investment Management will not receive a fee for managing this investment trust, unless they deliver a cumulative annual return in excess of 10%. The performance fee will be calculated on the following basis:

PF= ((A–B)×C)×15% where:

PF is the performance fee

A is the adjusted NAV per share

B is the higher of

(i) the high watermark NAV per share

(ii) the hurdle

C is the time weighted average number of shares in issue

If A–B is a negative number, it shall be taken to equal zero.

To earn a performance fee two goals need to be met. The first is to generate returns of more than 10% per year. Each year the 10% target is based on the shares' underlying asset value, not the share price itself. The second goal, a 'high watermark', ensures that a performance fee is paid only where the asset value is higher than its level when the previous performance fee was triggered. In other words, growth of 10% in one year won't trigger a payment if the investment had plunged for several years before and not yet fully recovered. Where both targets are met, a performance fee of 15% of the excess returns over a 10% cumulative hurdle rate per annum is paid. Most of this is paid in the form of shares in the trust, which is a further incentive to the management team to continue performing strongly. The small portion which is paid in cash is to cover taxes. They believe *"this innovative fee structure is a first in our industry. It aligns fund manager and investor and reflects the conviction that we have in this uniquely attractive investment opportunity. The ongoing charge covers the general administrative and management costs associated with running the trust"*.[53]

Equitile is a new asset management firm planned to launch late in 2015. It is developing a new approach to investing drawing on the lessons of the global financial crisis: *"We believe our financial system has become overleveraged, unnecessarily complicated and increasingly divorced from the needs of both investors and society. The root cause of these problems are flaws in the core ideas of economics and finance. We place debt, financial instability, behavioural finance and resilience at the heart of our thinking."* They are considering a system whereby a low *ad valorem* fee would be charged on enough of the assets under management to cover the costs and basic pay of the business and a performance fee on the rest.[54]

We wish to thank…

Tomorrow's Company thrives on complex projects of deep collaboration and shared inquiry. From this we find we can learn from the experience of market participants, develop agendas that make sense to practical people, and create a spirit of inquiry and shared commitment to future action.

In Tomorrow's Capital Markets we have had to go deeper and be more collaborative than most, while finding the route to shared action exceptionally complex! That means that our debt of gratitude is especially large. Below and opposite can be found a full list of our valued sponsors who made this work possible; our inquiry team who followed the logic and the complexity through to the finish, the many people on our steering and working groups and others that have kindly provided input along the way. I would like to extend warm thanks to all those mentioned or not mentioned, who were good enough to give up their time and share their experience and ideas.

Three people should be especially proud of the completion of this report, in spite of many difficulties. Throughout this process the intellectual and organisational ringmaster has been our director of research, strategy and policy, Pat Cleverly, and I would like to thank her above all for holding it together through its many stages. Aneta Dyakova worked closely with Pat as our senior researcher and I would like to acknowledge her professionalism and diligence. Finally, special thanks to Tony Manwaring, our CEO until the end of 2014, who has the credit for conceiving of and developing the project.

We are of course happy to confirm that final responsibility for what we say lies with Tomorrow's Company, and our acknowledgement of help and engagement from the people listed does not necessarily imply formal endorsement of the conclusions of the report.

Mark Goyder
Founder and chief executive, Tomorrow's Company

Sponsors
David Blood and Daniela Saltzman, Generation Investment Management and The Generation Foundation
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Katherine Garrett-Cox, Alliance Trust

Inquiry team
Damian Carnell, Towers Watson
Mike Clark, Russell Investments
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Alex Cowie, former senior research manager
Aneta Dyakova, former senior research manager
Jay Lingham, volunteer
Tony Manwaring, former CEO
Michael Petersen, volunteer
Alison Thomas, fellow
Philip Sadler, senior fellow
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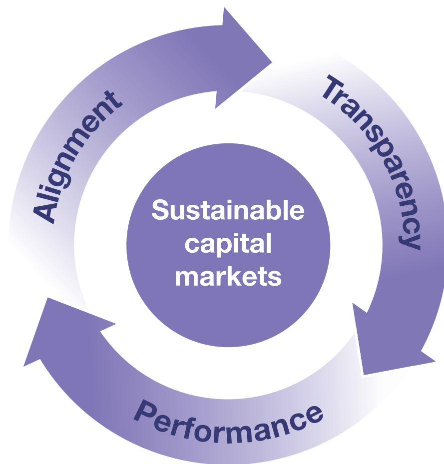
Mark Thompson, HSBC Pension Scheme
Lucy Tusa, Mercer
Mark Walker, Unilever UK Pension Fund
Michael Woodmore, Independent Trustee

Appendix: Extracts from Tomorrow's Capital Markets, 2012

The principles for incentives



Stewardship is the active and responsible management of entrusted resources now and in the longer term, so as to hand them on in better condition.

Alignment

- **To the interests of beneficiaries:** incentives take into account and are aligned to the needs and wishes of the ultimate beneficiaries, recognising the degree to which they wish stewardship to be taken into account. This should include both today's direct beneficiaries and future generations who will be affected by business decisions made today and the impact they have on future economic, social and environmental performance, acknowledging that to achieve this requires some difficult judgements and compromises to be made.
- **To business strategy:** the organisation's remuneration policy is in line with its stated long-term strategy, objectives and values, taking into account the interests of employees, suppliers, customers, community, the environment and society and should not encourage risk taking beyond the risk tolerance level of the organisation.

Transparency

The basis on which an organisation's reward packages are structured and paid is publicly available and communicated in a way that is easily understood and analysed.

Performance

- **Linked to sustainable outcomes:** benchmarks and other measures of performance include elements linked to material issues impacting on long-term success and sustainability
- **Link between reward and performance:**
  - there is a clear link between overall reward and the creation of value for the ultimate beneficiary, society and the organisation
  - the assessment of performance takes account of underlying business cycles of the firm and risks, and is set in a multi-year framework that prioritises the delivery of longer-term performance over short-term financial performance and/or comparative performance against a specified market index
  - bonus payments are once again designed to reward truly exceptional performance and are in the context of sustainable value creation.

Framework conditions

Leadership

Incentives operate within and are influenced by the culture of the organisation.

Strong leadership creates the conditions for incentives to achieve their intended outcomes – by CEOs and boards setting the right 'tone from the top', and by voluntary cross-industry initiatives and professional and industry bodies setting the appropriate guidelines.

Knowledge

- Investors and their advisers are better educated in financial matters and issues affecting the long-term sustainability of the economy, society and the environment so that investment objectives, risk parameters, time frame and returns, both financial and non-financial are incorporated into investment mandates
- Participants in the equity markets share knowledge about the non-financial drivers of sustainable performance – with others in the system and across existing silos created by internal functional boundaries
- Analysis and investment appraisal decisions take these non-financial factors into account.

Metrics

- Creative use is made of existing metrics and through better sharing of information across all the participants and expert bodies, the development of new metrics is hastened and their use encouraged by participants in the system in making investment decisions.

Information

- Information flows throughout the system are better aligned with investor needs and time horizons, and provide a more balanced and holistic view of strategy, risk and performance including:
  - the remuneration and incentive plans for the board and the principles for the rest of the organisation
  - the integration of material sustainability issues impacting long-term value creation
  - the culture and values of a company – the 'tone from the top' and how the board monitors corporate behaviour.

There are a number of initiatives that are progressing the above such as the work of the International Integrated Reporting Council (IIRC), the Global Reporting Initiative (GRI) and the Corporate Sustainability Reporting Coalition (CSRC).

Regulation

Regulators have set framework conditions that not only protect the interests of beneficiaries and the integrity of the system but also take into account issues affecting long-term sustainable outcomes.

Interactions and interdependencies (as at July 2012)

The pension scheme member and the company as pension plan sponsor

- In the past the incentive for a company to offer its employees a defined benefit pension fund with contributions from both employer and employees was straightforward. A sound, generous pension scheme, it was widely assumed, would aid in the recruitment and retention of employees.
- Many pension fund sponsors have found themselves facing substantial funding deficits. This has led to the creation of a strong incentive for many companies to either close their defined benefit schemes (or at least close them to new members), shift the risk from company to employee through setting up defined contribution schemes, or share the risk with the pension fund members through some form of hybrid pension fund.

The company as plan sponsor and pension fund trustees (PFTs)

- The pension plan must have an interest in ensuring that the company's financial policy and investment behaviour does not jeopardise the pension promise through paying out excessive dividends and taking too much risk.
- The sponsoring company has an interest in controlling the risks transferred back to it through the pension plan's own investment policy and therefore place pressure on trustees to ensure they are monitoring the fund closely to eliminate fund deficits and keep contributions to the minimum.
- PFTs who are also directors or senior managers of the sponsoring company experience a conflict of interest between the financial health of the company and the funding level of a defined benefit scheme. In many cases this conflict has been eliminated, as far as future service is concerned, by closing the scheme. But it is still a real issue in the case of past service, particularly when there is a significant funding shortfall, given that trustees have the power to call for the winding up of the scheme, with the potential consequence that the employer is forced into liquidation.

Pension fund trustees and investment consultants

- Pension fund trustees are rarely investment experts. They are therefore heavily reliant on the advice of investment consultants and, in the UK; they have a legal requirement to take such advice although they do not have to act on it. The prevailing interpretation of their fiduciary duties has become a 'lemming standard' as the duty to 'invest prudently' is set by reference to the behaviour of other investors. Many trustees fear that departure from these norms – however well-justified – could leave them exposed to legal liability.
- Investment consultants tend to charge a fixed hourly rate and therefore have an incentive to be active in order to maximise their income. They therefore offer an increasingly wide range of services that they encourage trustees to use.
- Pension fund trustees will monitor the performance of their investment consultants according to a number of criteria. These criteria are not generally related to the fund's performance. It can be argued that this is necessary as investment consultants are not the investment decision-makers, but it does create a misalignment of interests.

Investment consultants and fund managers

- Investment consultants have differing views on the key aspect of their role which adds most value for their pension fund clients. Some believe it is through advice on asset allocation while others believe it is through the fund manager selection process.
- Investment consultants advise on the selection of the appropriate benchmark against which the fund manager's performance is measured. They will also monitor performance and report back to pension fund trustees. These services form a central part of the value added by investment consultants.
- However there is the opportunity to generate substantial income through the fund manager selection process investment, so consultants may be incentivised to encourage fund manager turnover. However, clearly this should be balanced against the need to retain the client's business by not generating unnecessary expense.

Pension fund trustees and fund managers

- Where pension funds outsource investment management responsibilities to an external fund manager, the fund manager's remuneration is often tied to the size of funds under management. This incentivises fund managers to increase the size of the fund. This creates a challenge for active fund managers because the larger the fund the harder it is to create a portfolio that is significantly different from the index. Fund management fees vary according to the nature of the fund manager. Fees for segregated funds are higher than for pooled funds. Passive fund management fees are substantially lower than active fund management fees. There is a constant pressure for active fund managers to outperform the index to justify these higher charges. Evidence has shown that it is increasingly difficult to beat the index.

- The close and frequent monitoring of fund management performance by PFTs can also result in fund managers feeling pressured to maintain high levels of short-term performance relative to the benchmark to retain funds.
- Financial incentives are not the only incentives. Active fund managers will also wish to show good performance over the longer term, as this then allows them to build their personal reputation enabling them to move to a more lucrative role or set up their own funds in due course. Also, a PwC survey, conducted in 2011, found that culture and compensation were weighted equally as key areas of focus for the attraction and retention of talent and recommended that asset management firms continue to resist pressures to increase base salary and instead look to major on their culture as another way of retaining key staff.[56]

Sell-side analysts, brokers and fund managers

- Sell-side analysts' remuneration is largely tied to how the market rates the quality of research and advice provided. This often translates into an annual rating based on fund manager votes. Accordingly, for the highly ranked analysts one could argue there is a high alignment of interests.
- Brokers' remuneration is directly tied to trading volumes. As a result they have a powerful incentive to encourage market activity although this needs to be balanced against the desire not to acquire a reputation for driving churn.

Sell-side analysts, brokers and investee companies

- Sell-side analysts need to have good access to senior management within the companies they are covering to provide the kind of insight valued by the buy-side. This allows them to attain 'all-star' rankings, which has been found to drive higher levels of overall remuneration.
- Full service brokers benefit from association with high quality analysts in terms of reputation and hence business generation.

Corporate financiers and sell-side analysts

- As highlighted by the SEC in the US, analysts who work within the umbrella of a larger investment bank may have a potential conflict of interest around IPOs and new rights issues, however the existence of such a relationship should not be taken to automatically mean an analysts research is biased. There are strict codes of conduct, but research has shown that analysts may still feel under pressure to produce positive reports on the client company.

Corporate financiers and investee companies

- Corporate financiers' incentives are weighted towards deal completion. This can lead to a misalignment of interests as investment bankers' motivation to complete a deal may ignore what is in the longer term interests of the company and its shareholders.
- Senior management incentives may be tied to growth. In lieu of a long-term strategy pursuing organic growth some will instead favour growth through M&A activity as this offers the opportunity for greater near-term rewards.

Fund managers, stock exchanges and investee companies

- Nearly half of all exchanges are companies listed on their own exchange and are therefore subject to shareholder pressure to maximise returns. The largest sources of revenue for demutualized, for-profit stock exchanges are reliant on market activity. This results in an incentive for exchanges to create inducements for trading activity.
- Exchanges need companies to list on their exchange in order to generate activity. This creates an incentive for them to keep listing rules as simple as possible avoiding onerous conditions and associated costs. At the same time, exchanges need investors to have confidence in the companies listing on their exchange in order to encourage trading. This creates an incentive for them to put in place listing rules that ensure robust corporate governance. These two incentives are somewhat contradictory but in others mutually reinforcing, stock exchanges must strike a balance between the two.

Impact of the media

- The primary goal of the (financial) media is to increase revenue by reputation and size of readership. They do so by generating news and analysis that will maximise their audience, enhance their reputation and, accordingly increase their advertising revenues.
- There are large differences in the quality of news and information from financial media. At best they help provide useful information for investors, especially the retail investor. At worst they add to the noise which can obscure important information about fundamental company performance.

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and

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The Thinking Ahead Institute, an independent research arm of Towers Watson established by Roger Urwin and Tim Hodgson, seeks collaboration and change in the investment industry for the benefit of savers. Among its publications, it conducted a survey in early 2014 of UK- and US-based asset managers which identified that there is a core of people within the asset management industry who potentially see that it needs to change to better serve the ultimate beneficiaries. https://thinkingaheadinstitute.org/

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The B team, *The End of Business as Usual*. Available at: http://bteam.org/planb/#drive-full-transparency

Co-founded by former Puma leader Jochen Zeitz and Virgin tycoon Richard Branson, The B Team has committed to 'scale true accounting' as part of their aims. Examples include:

- Puma developed the first Environmental Profit and Loss (EP&L) statement.
- Natura building on their EP&L in 2015 by beginning the development of a Social Profit & Loss (S P&L), involving the assessment of social impacts on stakeholders in their value chain.
- The Tata Council for Community Initiatives (TCCI), has partnered with eXtensible Business Reporting Language (XBRL) to develop the TATA Index for Sustainable Human Development Taxonomy.
- Kering is applying enhanced EP&L methodology across all its brands (including Gucci, Stella McCartney and Volcom).

and

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and

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The overall vision of the Natural Capital Protocol (NCP) is to transform the way business operates through understanding and incorporating their impacts and dependencies on natural capital. It is seeking to create a harmonised approach to enable natural capital valuation to be practically used in applications e.g. internal management, reporting and disclosure. It is anticipated that the resulting framework would be the starting point to inform future standards.

[16] In December 2014, The European Securities and Markets Authority (ESMA) released its final technical advice in the implementation of MiFID II covering the use of dealing commission, derivatives, and high frequency trading. ESMA proposes that MiFID II should permit investment firms to accept third party research only where they pay for it directly or from a ring-fenced research account that is funded by a specific charge to their clients. There should be no payment for third party research linked to the payments made for execution of orders.

The Investment Association (IA) supports ESMA's stance on specific budgeting and separate charging as it would raise standards and reduce conflicts of interest across Europe and ensure that payments for research are clearly distinguished from payments for trading. It also supports the proposed requirement for brokers to offer to price execution and research separately, in order to help investment managers meet their obligations.

The Investment Association supports an enhanced Commission Sharing Agreement (CSA) between asset managers and investment banks where research payments could be deducted by brokers from a single payment made for a trade, subject to those payments not being linked to the volume of trading and subject to the budgets agreed with clients.

The FCA has already banned the use of dealing commissions to secure face-to-face meetings with company management and it is maintaining a more aggressive outlook on unbundling, most recently with FS15/1.

See also:

The Sustainability Accounting Standards Board (SASB) has developed a visual tool that helps users identify SASB disclosure topics on an industry-by-industry basis and compare the potential materiality of various sustainability issues across different industries and sectors. Corporations can use the SASB Materiality Map™ to focus their sustainability strategies on the most important issues and to understand the metrics that underpin each disclosure topic. Investors and other market participants can use SASB Materiality Map™ to analyse portfolio exposure to specific sustainability risks and opportunities represented by each issue.

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[19] See Watt et.al. *US Anger at Britain Joining Chinese-led Investment Bank AIIB*. The Guardian, 2015. Available at: http://www.theguardian.com/us-news/2015/mar/13/white-house-pointedly-asks-uk-to-use-its-voice-as-part-of-chinese-led-bank

[20] Reuters Business News. *China-led AIIB Will be Lean, Clean and Green – official*. Beijing: Reuters, 2015. Available at: http://uk.reuters.com/article/2015/04/12/uk-asia-aiib-idUKKBN0N302D20150412

[21] Aldersgate Group. *Thought Leaders Call for Greater Ambition for Green Investment Bank*. Aldersgate Group Press Release, 2014. Available at: http://www.aldersgategroup.org.uk/media/press-releases/thought-leaders-call-for-greater-ambition-for-green-investment-bank

[22] Green Alliance. *The Future of UK Infrastructure*. Green Alliance Content. Available at: http://www.green-alliance.org.uk/infrastructure.php

[23] In January 2015, the Greater Manchester Pension Fund (GMPF) and London Pensions Fund Authority (LPFA) announced that they will invest up to £500 million in major infrastructure projects over the next four years.

See: Out-Law from Pinsent Masons. *Local authorities team up to create £500m UK infrastructure investment platform*, Out-Law, 2015. Available at: http://www.out-law.com/en/articles/2015/january/local-authorities-team-up-to-create-500m-uk-infrastructure-investment-platform/ [accessed 19 May 2015]

[24] Tomorrow's Company defines it as *"the active and responsible management of entrusted resources now and in the longer term, so as to hand them on in better condition."* From: Tomorrow's Company. *Tomorrow's Stewardship: why stewardship matters*. Tomorrow's Company, 2011. Available at: http://tomorrowscompany.com/stewardship

[25] Financial Reporting Council. *The UK Stewardship Code*. Financial Reporting Council, 2012. Available at: https://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx

[26] Pensions and Lifetime Savings Association *The Pensions and Lifetime Savings Association Stewardship Disclosure Framework*. Pensions and Lifetime Savings Association. Available at: http://www.plsa.co.uk/PolicyandResearch/Corporate-Governance/Stewardship/Stewardship-disclosure-framework/FAQs.aspx

This was developed from work undertaken by the 2020 Investor Stewardship Working Party, of which Tomorrow's Company was a member, and published in: Tomorrow's Company. *2020 Stewardship: Improving the quality of investor stewardship*. Tomorrow's Company, 2012. http://tomorrowscompany.com/2020-stewardship-improving-the-quality-of-investor-stewardship-the-report-3

[27] Investment Management Association (now Investment Assocation). *Adherence to the FRC's Stewardship Code. At 30 September 2013*. Investment Management Association,2014. Available at: http://www.theinvestmentassociation.org/assets/files/surveys/20140501-01_stewardshipcode.pdf

The report summarises the responses of 82 Asset Managers, 27 Asset Owners and five Service Providers to a questionnaire that had been developed under the direction and oversight of a Steering Group chaired by the FRC's Chief Executive. Findings include:

- All respondents have a public policy statement on how they discharge their stewardship responsibilities under the Stewardship Code (Code Statement) and almost two thirds refer to or include their conflicts of interest policy within their Code statement.
- The proportion of asset managers where 'all' or 'some' mandates refer to stewardship increased to 83% from 71% in 2012.
- There was a significant increase in respondents' resource for engagement.
- More respondents to the survey give advance notice when they intend to abstain or vote against a resolution and voting records were disclosed publicly by 66% of respondents.
- There is particular engagement with companies on business strategy, board leadership, board composition and remuneration.

[28] The Stewardship Disclosure Framework has been promoted by the Pensions and Lifetime Savings Association. It is based on the work of the '2020 Stewardship Group'. See: Tomorrow's Company and the Investor Stewardship Working Party. *2020 Stewardship: Improving the quality of investor stewardship*. Tomorrow's Company, 2012. Available at: http://tomorrowscompany.com/2020-stewardship-improving-the-quality-of-investor-stewardship-the-report-3

In the UK, all asset manager signatories to the Stewardship Code have been invited to report against this.

[29] Standard Life Investments and Tomorrow's Company. *Building the momentum for effective investor stewardship – Recommendations for change*. Tomorrow's Company, 2014. Available at: http://tomorrowscompany.com/building-momentum

In Holland VBDO, The Dutch Association of Investors for Sustainable Development, has started to provide a stewardship ranking and benchmark to clients. (see VBDO. Benchmark Responsible Investment by Pension Funds 2013. VBDO, 2013. Available at: http://www.vbdo.nl/en/)

[30] Some of the UK's largest asset managers are calling for a kite mark for investment groups that offer a quality service. It would act as a stamp of approval that they carry out their roles as stewards of other people's money properly. This has been floated by two big investment groups in response to a regulatory investigation into asset management stewardship.

See: Oakley, D. *Large fund groups call for 'kite mark' of quality.* The Financial Times, 2015.
Available at: http://www.ft.com/cms/s/0/06bd37a4-b376-11e4-9449-00144feab7de.html#axzz3Xqxk3OnP

[31] The Investment Association set out their proposed models of disclosure and accountability in respect of charge and transaction cost information in the position paper:

The Investment Association. *Meaningful Disclosure of Costs and Charges – Position Paper*. The Investment Association, 2015. Available at: http://www.theinvestmentassociation.org/assets/files/consultations/2015/20150210-iacostsandchargesreport.pdf

[32] Financial Reporting Council. *The UK Stewardship Code*. Financial Reporting Council, 2012. Available at: https://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx

[33] Ibid 31

[34] CIMA and Tomorrow's Company with Integrated reporting <IR>. *Tomorrow's Business Success – Using Integrated Reporting to help create value and effectively tell the full story*. Tomorrow's Company, 2014. Available at: http://tomorrowscompany.com/tomorrow-s-business-success

[35] International Corporate Governance Network. *ICGN Securities Lending: Code of Best Practic*e. International Corporate Governance Network, 2007. Available at: https://www.icgn.org/file/599/download?token=Vu6g-24p

[36] Curwen, E and Costello, *M. Pension funds fuel short-selling moves*. The Times, 2014. Available at: http://www.thetimes.co.uk/tto/business/industries/banking/article4283376.ece

[37] The Investor Forum. Available at: http://www.investorforum.org.uk/---!about/c1kif

[38] Ibid 31. The report focuses on ten case studies providing evidence of engagement and its impact on corporate behaviour. The companies concerned were Barclays, Glencore Xstrata, AngloAmerican, Carnival, RSA Insurance Group, First Group, Lonmin, Bumi, Afren, and Redrow.

See also: Financial Reporting Council. *Developments in Corporate Governance and Stewardship 2014*. Financial Reporting Council, 2015. Available at: https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewardsh.pdf

[39] 'Aiming for A' Investor Coalition, made up of a range of large church, charity, local authority and individual investors was launched in 2012 as a new investor initiative to engage on climate change with the 10 largest extractives and utilities companies listed on the London Stock Exchange. The initiative is led by CCLA Investment Management. In February 2015, the BP Plc Board decided to recommend that shareholders accept the recently filed climate change resolution: 'Strategic Resilience for 2035 and Beyond'. The recommendation follows a similar announcement by the Royal Dutch Shell Plc Board a week earlier. The decision by the boards of two of the world's biggest oil companies to recommend the resolutions heralds a potential paradigm shift both in terms of corporate shareholder activism and an acceptance of the need to act on Climate Change by oil and gas producers.

See: The Church of England. *BP Board Advises Shareholders to Support Resolution on Climate Change at 2015 AGM*. Church of England, 2015. Available at: https://www.churchofengland.org/media-centre/news/2015/02/bp-board-advises-shareholders-to-support-resolution-on-climate-change-at-2015-agm.aspx

[40] See, for example:

HSBC: Incentive awards made to executive directors are delivered in the form of cash and HSBC Holdings plc shares. The total vesting period of deferred awards is no less than three years, with 33% of the award vesting on each of the first and second anniversaries of the date of the award and the balance vesting on the third anniversary of the date of the award. Where the total vesting period is three years, the share awards will be subject to a six month retention period upon vesting. GPSP awards are subject to a five year vesting period. On the vesting date GPSP awards are subject to a retention requirement until cessation of employment.

HSBC Bank plc. *Annual Report and Accounts 2014*. Available at:
https://www.hsbc.co.uk/1/PA_esf-ca-app-content/content/pws/content/personal/pdfs/hbeu-2014-ara-final-online.pdf

In October 2014, it was reported that Coca-Cola was overhauling its executive-compensation plan to take effect in 2015, scaling back stock options and shifting to more cash-based performance awards. The reversal by the world's largest beverage company – which championed the original plan at its April shareholder meeting – follows criticism from billionaire investor Warren Buffett and other Coke shareholders who called the equity plan excessive.

From: Esterl, M. and Lublin, J. *Coke scales back executive equity bowing compensation, bowing to pressure*. The Wall Street Journal, 2014. Available at: http://www.wsj.com/articles/coca-cola-tweaks-executive-compensation-plan-1412170448

[41] PwC. *Making executive pay work: the psychology of incentives*. PwC, 2012. Available at: http://www.pwc.co.uk/human-resource-services/publications/making-executive-pay-work.jhtml

[42] Ibid 31. In May 2014, following a review of funds' marketing material for retail investors, the FCA encouraged fund providers to use combined charges figure, such as the ongoing charges figure (OCF), in all documents.

In November 2014, the Financial Services Consumer Panel, an independent body that advises the City regulator on policy, proposed that funds groups offer investors a single charge which would include all intermediation costs, charges and expenses incurred by the manager, including transaction and dealing costs, which are not fixed or necessarily known upfront.

[43] CFA Society United Kingdom. *Fees and compensation: position paper*. CFA Society, 2013. Available at: https://secure.cfauk.org/assets/3769/CFA1192_Fees_Comp_Position_paper_v2.pdf

[44] Belogolovky, E. and Bamberger, P. *When pay is kept secret, the implications on performance are revealing*. Cornell University, Center for Advanced Human Resource Studies, ILR School, 2013. Available at: http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1031&context=cahrs_researchlink

[45] See:

The work of Professor Edward E. Lawler III. Director of the Center for Effective Organizations and Distinguished Professor of Business at the University of Southern California.

Ramachandran, G. *Pay transparency* (18 August 2011). Penn State Law Review. Vol. 116, No. 4, p. 1043, 2012. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1925604

Timms, M. *Pay secrecy could soon be a thing of the past*. World Finance, 2014. Available at: http://www.worldfinance.com/strategy/pay-secrecy-could-soon-be-a-thing-of-the-past

Henneman, T. *Pay transparency: paid in full disclosure*. Workforce, 2015. Available at: http://www.workforce.com/articles/21190-pay-transparency-paid-in-full-disclosure

[46] Lighbown, A and Sills, P. *Theonomics*, Sacristy Press, 2014, pp59-60.

[47] PwC. *Financial transaction tax: The impacts and arguments. A literature review*. PwC, 2013. Available at: http://www.cbi.org.uk/media/2482473/FTT_impacts_and_arguments.pdf

[48] Cameron, W.B. *Informal Sociology: A Casual Introduction to Sociological Thinking*, Random House, New York,1963

[49] Meadows, D.H. *Leverage Points: Places to Intervene in a System*. Available at: http://www.donellameadows.org/archives/leverage-points-places-to-intervene-in-a-system/

[50] Mercer. *Investing in a Time of Climate Change, 2015*. Available at http://www.mercer.com/services/investments/investment-opportunities/responsible-investment/investing-in-a-time-of-climate-change-report-2015.html

[51] Sir Winfried Bischoff, Chairman, Financial Reporting Council. Keynote Address, NAPF (now the Pensions and Lifetime Savings Association) Stewardship Conference, *Being Responsible Owners*. FRC, 2014. Available at: https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Speech-by-Sir-Winfried-Bischoff-at-the-NAPF-Being.pdf

[52] Orbis Access Investment. *Orbis Access Fee Explained*. Orbis Access. Available at: https://static.orbisaccess.co.uk/public/5.23.0/media/658845/Orbis-Access-Fee-Video-Transcript.pdf

[53] Woodford Investment Management. *Woodford Patient Capital Trust – Fees*. Woodford. Available at: https://woodfordfunds.com/our-funds/wpct/fees/

[54] Equitile – Evolution in Finance. Available at: http://equitile.com/

[55] Johnson, K. *Back to the Future of Pension Trust Fiduciary Duties Protecting Our Best Interests Seminar*. FairPensions & Cass Business School, 2010. Available at: http://shareaction.org/sites/default/files/uploaded_files/KeithJohnsonFiduciaryDuty.pdf

[56] PwC. *Paying a premium for the best investment professionals*, PwC Asset Management Reward Survey, 2011. Available at: http://www.pwc.co.uk/assets/pdf/pwc-asset-management-reward-survey-2011.pdf

[57] See: US Securities and Exchange Commission. *Analyzing Analyst Recommendations*. US SEC Investor Publications, 2010. Available at: http://www.sec.gov/investor/pubs/analysts.htm

and

Cullen, A. *The Bias of Wall Street Analysts*. Harvard Business School Q&A with Bradshaw, M.T, 2004. Available at: http://hbswk.hbs.edu/item/4430.html

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