The Kay Review
Department for Business, Innovation and Skills
Spur 1, Floor 3
1 Victoria Street
London SW1 H0E

27 April 2012

Dear The Kay Review

The Kay Review of UK Equity Markets and Long-Term Decision Making: Further Call for Evidence

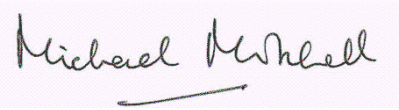
Thank you for giving us the opportunity to take part in the above consultation. I am pleased to enclose The Investor Relations Society's response. We were unable to provide a response to the first round consultation, but having seen the interim report we felt it was important to add some of our views.

The Investor Relations Society's mission is to promote best practice in investor relations; to support the professional development of its members; to represent their views to regulatory bodies, the investment community and government; and to act as a forum for issuers and the investment community. The Investor Relations Society represents members working for public companies and consultancies to assist them in the development of effective two way communication with the markets and to create a level playing field for all investors. It has over 600 members drawn both from the UK and overseas, including the majority of the FTSE 100 and much of the FTSE 250.

As the professional body representing UK in-house Investor Relations Officers and their advisors, with the responsibility for liaising with the buy and sell sides in maintaining relationships with current investors, attracting new ones, and acting as a two-way communication function between issuer and capital, we are keen to explain the issuer

perspective with respect to the subject of equity markets and long-term decision making and the thought-processes outlined in the interim report ahead of recommendation to Government. We do this by referencing some of the key topics of interest for our members discussed in the interim report: the question of mandatory quarterly reporting in the corporate landscape; the issue of 'stewardship' and investor engagement; 'short' and 'long' termism and investors; and diversification and internationalisation of UK share ownership. In particular we wish to highlight the challenges faced by issuers in attracting and maintaining investment capital. By taking this approach we seek to provide useful feedback and explain our members' perspectives on the aforementioned issues.

Yours sincerely



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Quarterly reporting

It seems clear from the interim report that The Kay Review is seeking to bring to an end mandatory quarterly reporting for UK listed companies. Professor Kay has separately stated: "*Almost no one supports the obligation on listed companies to produce quarterly accounts or interim management statements'…The tyranny of quarterly earnings has created a dysfunctional cycle of smoothed and exaggerated numbers and relations between companies and analysts based on earnings guidance, an activity almost unconnected to the real business of the company and to assessing its progress".* Meanwhile, the EU is also seeking to end mandatory IMS and proposes that: *"Under the proposed revision of the Transparency Directive, listed companies, including small and medium-sized issuers would no longer be obliged to publish quarterly financial information."*

However, in discussions with our members we have found that they have nearly all said they would probably continue with four to six earnings announcements per year because *"the market has come to expect it"*. This offers a different view from the consensus view of the interim report in which views quoted are critical of the quarterly reporting cycle. One reason for this is that with the increased diversification of UK companies' share registers (please see our section on this below) and specifically the levels of ownership amongst US investors - North America accounts for 56% of the 41.2 per cent of the overseas held value of the UK stock market according to ONS' Ownership of UK Quoted Shares 2010 - UK companies recognise that US investors expect quarterly reporting, as is the norm in the US, and not to do so puts them at a potential disadvantage. More importantly, our members also inform us that reporting on a regular basis is viewed as enhancing transparency. There is the further consideration that a programme of calendarised announcements allows companies to report uneventfully and routinely without causing an unwarranted stir in the market. In-house IRO's are particularly keen to retain 3 month regular reporting in order to keep the market fully and equally informed and to ensure there are no issues around selective disclosure at the regular investor meetings they hold.

These points should not be seen as presenting the case for retaining mandatory quarterly reporting. Indeed, we feel that scrapping this obligation would allow greater flexibility for companies with regards to their reporting schedule. However we would point out that if, as the interim report appears to favour, quarterly reporting is made non-obligatory, we expect from our discussions with members that they will continue in this eventuality to report at least four times a year, or as the market requires. The role of analysts is important here due to the importance that they place upon certain types of information by sector; for example, retail

sales figures during the Christmas period. It should also be noted that the FSA/UKLA DTR rules and the Companies Act 2006 require price sensitive information to be disclosed as soon as possible so reporting on a regular basis (if not calendar) will remain mandatory. Furthermore, the FSA interpretation of the disclosure rules to require the announcement of all material information, even though the net effect might be non-material, tends to increase the number of announcements which companies are obliged to make.

Stewardship

As the report identifies, asset managers are the 'stewards' of the funds their clients invest into. There is in addition a debate currently over whether they can (or should) be stewards of the companies they take positions in on behalf of their clients. It is the latter that we, as an issuer organisation, have our focus on. Advocates of this type of stewardship recommend it as offering a counter balance to short termism in UK capital markets through encouraging investor engagement, with investors in turn attracted by the prospect of higher long term sustainable returns.

We contend that issuers have been actively engaging with the buy and their sell sides through their investor relations departments for a considerable time and that, in fact, this process is improving. As part of our response to this consultation we carried out a special mini-survey investigating our members' engagement with their investors. We found that 68% of our members report that more than 80% of their top 10 investors are **actively engaged** with the company, and that **86% meet with their top ten investors more than once a year**. We have also recently held a meeting (IR Policy Forum) where representatives from some of the UK's largest fund managers met with a cross section of investor relations directors to discuss how the two groups encourage dialogue around the core principles of stewardship. Overall it was felt that many investors were already conforming to best practice in communication with companies, and that the 2010 Stewardship Code has resulted in *some* improvements regarding engagement of smaller investment funds (although it is clear that there is a long way to go before the Stewardship Code can be judged as a success). Drawing on this, we query the impression given in the interim report that stewardship in the context of issuer-investor engagement is declining. While we certainly recognise there is more than can be done in this area, we would not like to create obligations to have unnecessary events or a box ticking mentality to 'prove' that stewardship obligations had been fulfilled. Our members have also pointed out that there is often a lack of communication between fund managers and the corporate governance departments within the same organisation – with the latter probably more inclined to take up the stewardship

agenda.

There are other obstacles to effective stewardship. The interim report is in our view weighted towards the perspective of investors. Issuers, through their investor relations departments, make great efforts to engage with their investors to explain company strategy and relay market perceptions back to management, and indeed our members frequently report that at times they have difficulty in securing investor time. Furthermore, the growth of the proxy advisory firms has created another layer of intermediaries between issuers and investors. Our members report that, on occasions advisory firms have recommended particular courses of action to their clients (the underlying shareholder) without necessarily understanding the detail of the issue and without checking their facts with the issuer. . Ultimately it is issuers that control the message and this requires understanding by all parties in discussions of stewardship and investor engagement. IR departments have a key part to play in explaining underlying competitive strengths and peer group differentiation points to investors.

Communication with short and long term investors

The interim report discussed the difficulties in overcoming short term thinking, from fund managers not taking the risk of moving too far from their benchmark index over short periods, to the excessive scrutiny of company management over short term share price fluctuations. We see investor relations as fundamental to overcoming short-termism: it is the role of IR teams to explain and report company strategy to give a true and fair perspective of current and future performance. Equally, in turn, they relay market messages back to senior management with the overall objective of allowing investors to make accurate investment decisions for the long term, while reassuring CEOs that weekly share price moves are, in general, unlikely to be critical (notwithstanding specific circumstances that might be!) In the context of this review we feel this is a key point to make.

Our view is that guidance is a key way in which companies offer short and long term investors the information required to allow them to set their investor timescales. While it is important that analysts and fund managers do not become preoccupied with earnings guidance we feel this offers great benefits to asset managers and it is an important way in which analysts are able to create their earnings estimates. It is our view that investors welcome the transparency that guidance delivers in allowing them to gauge future expectations of financial performance, while enabling the company to monitor its own internal expectations of performance against the market's view, and if necessary, take

action. Issuers, however, become frustrated when earnings estimates are incorrectly aggregated by third party suppliers creating false expectations in the market. No concerned party wishes to see a situation whereby transparency in the interest of long term decision making is threatened by issuer concerns over short term consequences of externally compiled estimates, which are not accurately portraying the company's figures. Overall, we consider that the provision of public guidance on a company's current trading and future prospects to be best practice. The exact form that guidance may take and the combination of narrative and data points provided will depend on the nature of an individual company's business model and its established practice.

We recognise that there is focus from Boards on short-medium term share price (with horizons of 12-18 months) because often Board incentive payments are tied to share price performance. While this raises the potential for short term decision making by Boards, it also highlights the conundrum of how to align Board room incentives with shareholder interests. Without short-medium term incentives how then to avoid boardroom complacency while at the same time allowing Boards to pursue strategic objectives? With increased investor focus on executive remuneration – in another recent survey 30% of our in-house IR members reported that investors are clearly or somewhat more engaged with investors regarding executive remuneration than one year ago, with 77% of the opinion that IR teams will be more involved in discussions with investors about executive remuneration in the future - issuers are increasingly faced with the pressure to justify executive pay against performance and it is in the nature of media and commentators to look to share prices as a guideline.

We also feel that issuers are often faced with persuasive demands from investors on company strategy that are both short term and liable to change within small timeframes. A good example of this is investor calls for companies to return capital to investors through share buybacks only to be questioned over a perceived lack of a growth programme a short while after. It takes a strong Board to resist investor calls to raise the share price in this way.

In all of this it is important to remember from the issuer perspective, short termism is not in itself undesirable per se. Short term investors are essential for providing liquidity. Short term investors, while seeking to attract a significant yield, often take greater risks than long term ones and deserve to be treated in the same way by companies. It is not desirable for markets to become homogenised and undermining investor diversity runs the risk of raising the cost of capital and creating friction within the market. Companies consider the interests and requirements of both short and long term investors when reporting, and in investor meetings it is more common to discuss market position with all investors than in the past.

Internationalisation and share ownership

As the ONS' Ownership of UK Quoted Shares 2010 report shows there has been rapid growth of international ownership of UK equities in recent years. The US is a particular source of investment capital for UK quoted firms. The effect of internationalisation has meant IROs put on road shows around the world and compete for the same pools of capital for overseas domiciled peers. There is the understanding that in a smaller world it is much easier for investors and issuers from different locations to get access to each other, either in person or using technology. Our members find that large international investors will take a similar close interest in UK companies in which they hold stock, as UK investors do, and that these larger overseas investors are very likely to take long term positions in UK companies following (on-going) satisfactory meetings with management and IR teams. We consider that generally speaking internationalisation has had a positive impact on the overall number of meetings between company and investors, and therefore for long term engagement. Due to the nature of international investment, most foreign investors taking stakes in UK companies tend to be on the larger scale and therefore have the wherewithal to arrange meetings as required. We do not consider there has been an impact on UK investor and UK issuer engagement as a result of this process.