

SHAREHOLDER SHORT-TERMISM IN THE UK: THE KAY REVIEW AND THE POTENTIAL ROLE OF CORPORATE LAW

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Abstract

This paper examines the notion of short-termism and assesses the potential impact of short-termist shareholder pressures on corporate governance in light of available empirical evidence on the effects of institutional shareholder ownership on corporate performance. Its main aim is to evaluate the adequacy of the recommendations included in the influential Kay Report and to assess the legal efficacy of the regulatory tools advocated by Kay. It is argued that although most of the Report's recommendations are likely to alleviate the consequences of short-termism, the Report does not go far enough to ensure a definite change of culture and practice in equity markets. Therefore, further reforms are necessary in the area. In particular, it is expedient to robustly reform the structure of executive remuneration, facilitate a dialogue between companies and long-term investors, and reform shareholder voting rights to deter short-termist behavior and reward long-term investors.

Keywords: Kay Report, Institutional Investors, Shareholder Activism, Short-Termism, Equity Markets, Corporate Governance Reform

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1. Introduction

The Kay Review's Final Report, published in 2012, is based on a powerful idea. Instead of permitting market structures that create perverse incentives and then attempting to regulate conduct using specific rules, it would be more effective to implement structural reforms that put in place appropriate incentives.

This paper examines the notion of short-termism in the investment chain and assesses the potential impact of short-termist shareholder pressures on corporate performance. To do so, it explores the main ways by which the short-term preferences of certain investors affect decision making by corporate directors. The main purpose of the paper is to critically evaluate the adequacy of Kay's main policy recommendations in light of broader empirical evidence on the effect of strong institutional shareholding on corporate performance.

I propose to structure the paper as follows. Section II provides an overview of the findings and recommendations of the Kay Review. Section III examines the interplay between shareholder passivity and short-termism and explains why the causes of passivity also contribute to the problem of short-termism. Section IV offers empirical evidence on the consequences of short-termist shareholder pressure from the banking industry. Section V critically

examines the potential efficacy of the policy recommendations of the Kay Review. In light of these findings, Section VI explores a series of corporate law and corporate governance reforms that could potentially reduce the scope for shareholder short-termism and its impact on UK companies.

2. A concise overview of the Kay Review's Final Report

Professor John Kay was commissioned in 2011 by the Department of Business, Innovation and Skills (BIS) to investigate UK equity markets in order to assess the impact of their function on long-term decision making by UK companies, subsequent to a BIS consultation (BIS, 2010). The final report was published in July 2012 (Kay, 2012a) and was preceded by an Interim Report earlier in 2012 (Kay, 2012b). The report has been received positively by the BIS Select Committee which urged the Government to take action to implement its main recommendations, and cautioned against exclusive reliance on voluntary self-regulation by market players as the latter may be an ineffective tool to achieve the radical change of practice and culture that is required (BIS, 2013: 134-135). Indeed, the Government committed to review progress on the implementation of the report by summer 2014 and accepted in principle the normative findings of the Review, and the potential need for legislative and

regulatory changes in the area in due course (BIS Committee, 2012).

Crucially, the Kay Review seeks to ascertain whether hyperactive trading by some institutional investors and the overall effect of equity markets have negatively influenced UK companies. Evidence shows that investment by UK companies has declined over the past 10 years (Kay, 2012a: 1.16). In addition, research and development (R&D) expenditure by UK companies as a percentage of the country's GDP has consistently been significantly lower than the relevant expenditure of American, German and French companies (Kay, 2012a: 1.18). A substantial part of the Review is devoted to a critical examination of the dominant paradigm of financial markets, that is, the efficient capital market hypothesis and in particular its strong version. The Review observes that this is based on a theoretical abstraction rather than on empirical evidence and that recent experience from the dot.com bubble, the securitised debt instruments during the recent crisis, and the European sovereign debt crisis demonstrates that markets may misprice securities for a long period of time.

Turning now to the recommendations of the Review, Professor Kay focuses on restoring trust in the equity investment chain. It is recommended that the Stewardship Code is expanded to incorporate a more demanding concept of stewardship (Kay, 2012a: 6.3) The Review doubts the value of imposing further disclosure obligations (Kay, 2012a: 6.16) and calls for deeper and stronger relationships between the parties to the equity investment chain (Kay, 2012a: 6.14). To achieve these ends, the Review proposes a series of Good Practice Statements that should be adopted by company directors, asset managers and asset holders; and this has been encouraged by the Government (Kay, 2012a: 6.22). A particular aim of the Review is to encourage engagement in companies by asset managers. To facilitate co-ordination between them, the Review proposes the creation of an investors' forum (Kay, 2012a: 7.3 - 7.7).

The Good Practice Statement for asset managers proposed by the Review focuses on recognising that asset managers are in a position of trust and have a duty to provide relevant information to clients. In addition, asset managers are recommended to focus on long-term value creation, absolute returns and their readiness to engage with investee companies (Kay, 2012a: 7.21). The equivalent statement for asset holders requires them *inter alia* to provide relevant information to their beneficiaries and to set the mandates for asset managers in a way that focuses on absolute long-term objectives rather than on relative short-term performance (Kay, 2012a: 7.31). Finally, the Good Practice Statement for corporate directors encourages them to acknowledge that long-term value creation is best served by focusing on investing rather than by treating companies as 'portfolios of financial assets.' It calls for directors to facilitate a dialogue with shareholders, to provide forward-looking

strategic information and be paid in a way that creates appropriate incentives (Kay, 2012a: 8.4).

In parallel, it proposes that companies should consult their main long-term shareholders in advance of major board appointments; such as the appointment of a new chairman or key independent directors (Kay, 2012a: 8.36). Another major policy recommendation of the Review is that UK and EU regulators should use fiduciary standards to assess the behaviour of all players in the equity investment chain and that these standards, revolving around the core notion of loyalty, should take primacy over contractual terms (Kay, 2012a: 9.12 - 9.15). In this context, the Review invites the Law Commission to clarify the legal concept of fiduciary duty as applied to investment (Kay, 2012a: 9.21 - 9.22). With regard to corporate reporting, the Review supports the abolition of mandatory quarterly financial reporting and emphasises the need for succinct and informative corporate reports (Kay, 2012a: 10.19 - 10.22). In addition, the Review is cautious of the value of metrics and models used to assess performance in the equity chain and calls on the Government to launch an independent review of their merits, and on the relevant regulators to abstain from prescribing any particular model of risk assessment, but rather to encourage companies to use their own substantial judgement (Kay, 2012a: 10.30).

The final main area of reform identified by the Review is remuneration design for both corporate directors and for asset managers. The Review recommends that companies should pay all variable remuneration in shares which should be held at least until the executive director retires (Kay, 2012a: 11.09 - 11.12). However, the exact scope of this recommendation is not clarified. Similarly, it is proposed that the executives of asset managers are rewarded with an interest in the fund that they have to maintain until they are no longer responsible for managing that fund (Kay, 2012a: 11.13 - 11.16).

3. Shareholder passivity and short-termism: a conceptual framework

This section argues that one of the main reasons for the short-term attitude of most shareholders is that they face substantial economic incentives to remain passive. The link between obstacles to shareholder engagement and shareholder short-termism is an indirect one. Generally, shareholders have two main ways to react when they are unhappy with the performance of a company: to engage with the company using their voting rights (voice option), and to sell their shares (exit option).

If engagement is too expensive, shareholders will rationally prefer to exit companies whenever they are not satisfied with the company's performance. This creates a disincentive to long-term engagement with companies for the following reason. The main benefit that long-term investment can bring is that

shareholders can have a positive impact on the performance of the investee company by actively engaging, monitoring managerial performance and promoting better strategies. If such engagement is not feasible, there is nothing to be gained by holding a substantial percentage of shares for a long period of time. It therefore makes sense to diversify the investment portfolio as much as possible and to trade frequently. At the same time, there are common causes to both phenomena. The lack of an adequate understanding of the inherent value of companies both discourages shareholder involvement and encourages a short-term trading attitude; this is due to the prevailing investment strategy which is not one of identifying good investment opportunities, but rather one of speculation on the short-term fluctuation of share prices. It is necessary, therefore, to closely examine the extent of and reasons for shareholder passivity in order to ascertain the persistence of short-termism as a problem of UK equity markets and the adequacy of Kay's recommendations to address it.

The main reason why shareholder activism is an exceptional phenomenon is the lack of economic incentives for shareholders to participate actively in corporate decision-making. In widely held companies, no shareholder owns a controlling block of shares. This means that, in normal circumstances, no individual shareholder acting alone can determine the outcome of a shareholder vote (Black, 1991: 821). Activist shareholders therefore have no option but to form a coalition with other shareholders in order to increase the possibility of winning a vote against the board. Forming and maintain such coalitions is of course costly and requires adequate resources being available. At the same time, the potential benefit from activism is relatively small. Indeed, the benefit to be gained is proportional to the percentage of shares owned by a particular investor. However, as the benefit is equally spread among all the shareholders, each shareholder is tempted to remain passive and wait for someone else to engage. And it may still be the case that the activist shareholders' preferred strategy was not in fact superior to the one proposed by the board.

The preceding analysis indicates that institutional shareholders are better-placed to be active than individual shareholders. This is for two main reasons. First, institutional shareholders tend to own more shares than other types of shareholders, and usually have a higher level of business expertise, enabling them to develop informed opinions at relatively low cost. Secondly, since a limited number of institutional shareholders hold substantial blocks of shares in all or most UK listed companies, it should not be difficult for leading institutions to form a coalition when necessary.

However, institutional shareholder activism never became a dominant characteristic of UK corporate governance. Institutions have been relatively successful in promoting shareholder rights

and certain corporate governance norms at an industry-wide level. Pressure by associations of institutional investors such as the Association of British Insurers and National Association of Pension Funds has prevented UK companies from disapplying pre-emption rights and from issuing multiple-voting shares. In addition, the whole corporate governance movement which resulted in the highly influential Combined Code (now the UK Corporate Governance Code) has been strongly influenced by institutional investors. Conversely, at the micro level of individual companies, institutions have been less active. In the vast majority of cases they prefer to sell their shares rather than to attempt to change a company's strategy. Of course, the rarity of open confrontation with corporate managers is to an extent explained by the tradition of informal communication with boards of directors. Still, anecdotal evidence and interviews indicate that UK institutional shareholders do not form coalitions often and normally vote in favour of the board, unless there is a corporate crisis or scandal (Black, 1993). In parallel, a series of empirical studies have indeed failed to find any evidence that UK institutional investors actually engage in monitoring their investee companies. For instance, Goergen et al conclude that institutional shareholders do not monitor investee companies either by direct intervention or behind the scenes (Goergen, Renneboog & Zhang, 2008; Mayer and Renneboog, 2001). Overall, the level of institutional engagement has traditionally been unjustifiably low and remains so in present times (Myners, 2001).

The reluctance of institutional shareholders to engage with investee companies is due to the combined effect of three factors, namely: (i) agency costs arising out of a long chain of intermediation between the ultimate investor and the investee company; (ii) conflicts of interest faced by institutions that have close business links to companies; and (iii) a lack of expertise on the part of the staff employed by institutional investors. A detailed discussion of these issues falls outside the scope of this paper.

The increasing fragmentation of share ownership in UK public companies in recent years further weakens shareholders' incentives to take a long term interest in companies and hence exacerbates short-termism. As compared with the early 1990s, there has been a dramatic erosion of the position of domestic institutional investors. Both the volume and percentage of shares held by pension funds and insurance companies has fallen sharply, as can be clearly seen in the next table. In 1993, British institutional investors (including banks) owned approximately 61% of the shares in UK listed companies. In 2010, they owned only 25% of the shares. At the same time, the percentage of shares owned by foreign investors has more than doubled from 16% to 41.2%. The effect of the increased internationalisation of share ownership is that the potential for shareholders to co-ordinate is now more

limited. There has also been a dramatic increase in the percentage of shares owned by other financial institutions (including hedge funds), from merely 1% in 1993 to 16% in 2010. These investors tend to take a

short-term investors approach and hence their presence is associated with an exacerbation of short-termism.

Table 1. Percentage of shares owned by different types of investors
(The data is taken by the Office of National Statistics)

	1993	1998	2008	2010
Foreign	16%	30.7%	41.5%	41.2%
Pension funds	32%	21.7%	12.8%	5.1%
Insurance companies	20%	21.6%	13.4%	8.6%
Unit trusts	6%	2%	1.8%	6.7%
Investment trusts	2%	1.3%	1.9%	2.1%
Banks	1%	0.6%	3.5%	2.5%
Other financial institutions	1%	2.7%	10%	16%
Non-financial companies	1%	1.4%	3%	2.3%
Individuals	18%	16.7%	10.2%	11.5%
Church/ charities	2%	1.4%	0.8%	0.9%
Public sector	1%	0.1%	1.1%	3.1%

4. How serious is the problem of shareholder short-termism? Evidence from the banking sector

The reason I present evidence from the banking sector is due to the availability of bank-specific empirical studies this being prompted by the recent crisis, and the relevance of such examples to the issue of short-termism. Erkens et al examined the impact of institutional ownership on the stock returns of 296 financial firms from 30 countries during the 2007-2008 period (Erkens, Hung & Matos, 2012). They found that firms with higher institutional ownership experienced worse stock returns during the crisis. To further explore this finding, the authors tested whether higher institutional ownership led to more risk-taking and concluded that firms with a higher institutional ownership took on more risk before the crisis, which evidently caused them to perform worse during the crisis. This study is highly relevant for the case in point, since the percentage of a bank's shares that are held by institutional shareholders is a good proxy for overall shareholder intervention. The findings of the study imply that institutional shareholder activism is on balance destabilising for banks as the negative consequence of increased risk-taking seems to outbalance the positive aspects (lower agency costs).

The most notable case of such shareholder behaviour was the revolt of Knight Vinke Asset Management LLC (an institutional asset manager headquartered in New York) against the management of HSBC. In 2008 Knight Vinke publicly opposed HSBC's decision to increase its share capital by 20% to cope with the financial crisis. They argued that the capital increase would harm the financial interests of existing shareholders. As an alternative strategy, they proposed that HSBC allows HSBC Finance Corporation (HFC), one of its subsidiaries in the US, to seek Chapter 11 protection (Knight Vinke, 2008). Household International was a US financial company

acquired in 2003 by HSBC and renamed HFC. It was heavily exposed to the US sub-prime mortgage market. Its failure would be detrimental to its bondholders and would probably lead to the withdrawal of HSBC's authorisation to engage in banking in the US. Furthermore, it would undoubtedly severely affect its global reputation. HSBC's board successfully resisted the pressure, and proceeded with the capital increase. Similarly, in 2007, Knight Vinke had opposed the strategy of HSBC to seek continual geographic diversification (Knight Vinke, 2007). Such diversification, although not likely to lead to profit maximisation, would materially decrease the likelihood of the failure of a bank (Coffee, 1986: 52 - 72).

Activist shareholder pressure has also been experienced by Barclays under similar circumstances i.e. as opposition to a decision that aimed to strengthen the financial position of the bank but was not profit-maximising for its shareholders (at least in the short term). Indeed, in 2008, Barclays decided to increase its equity capital by £7.3 billion to cope with the financial crisis. It rejected an offer from the UK government for assistance, and instead sought to raise the capital from private investors. Several shareholders protested that this course of action was more costly to Barclay's current shareholders than accepting government aid. As a result, the whole board put itself up for re-election in the next annual meeting in 2009. The board argued successfully that accepting government aid and hence public intervention would not be in the long-term interests of Barclays.

Conversely, the shareholders of UK banks have consistently welcomed any strategies that increase the leverage and hence the riskiness of banks, often to the detriment of the bank's long-term sustainability. For instance, the shareholders of RBS overwhelmingly supported the catastrophic acquisition of ABN Amro and the shareholders of Northern Rock approved the

exponential debt-financed growth of the bank (Kay, 2012a: 1.29 – 1.30). Also, there is evidence that the shareholders of RBS continuously pressed for (unsustainable) levels of return and encouraged an extremely leveraged business model, which turned out to be fatal for the bank (Parliamentary Commission on Banking Standards, 2013: 174).

Of course, evidence from the banking industry should be treated with some caution when used to assess the overall problems caused by short-termism in UK companies. Banks are different from other companies with respect to their riskiness, capital structure and interconnectedness. Still, the above evidence suggests that short-termist pressures by shareholders can be a substantial problem for UK public companies as they are prone to lead to excessive risk-taking which is bad for the long-term performance of companies, and to a misconceived managerial focus on financial restructuring rather than on substantial value creation.

5. The inadequacy of voluntary self-regulation and fiduciary duties to effectively tackle shareholder short-termism

The preceding analysis suggests that the causes of shareholder short-termism are deeply rooted in the main characteristics of widely-held companies and demonstrates that short-termism can be a serious problem with potentially deleterious consequences to corporate performance and financial stability. In this section, I argue that the Kay Review, despite its insightful exploration of the phenomenon and its laudable approach of creating appropriate incentives to tackle short-termism, does not go far enough to achieve its goals.

The main problem with the Review is its heavy reliance on self-regulatory statements of good practice that allow flexibility but are inevitably broadly phrased and indeterminate. To this regard, the Review follows the long-established UK practice of preferring soft-law rules over mandatory regulation, which has been championed by the corporate governance movement since the 1990s (Cadbury Committee, 1992), and has been followed by the Stewardship Code (FRC, 2012) and the Walker Review on banks (Walker, 2009). However, the potential of self-regulation to be effective depends on the availability of market pressure to ensure compliance, as has been the case with the UK Corporate Governance Code (FRC, 2012). In the context of equity markets, such pressures would be unlikely to arise. The same economic reasons that encourage short-termism will inevitably encourage corporate managers, asset managers and asset holders to avoid substantial compliance with the best practice principles, and no party will monitor if other parties comply since they all face strong incentives to behave differently. The Good Practice Statements proposed by the Review

would be truly effective only if combined with legal reforms that would change the incentive structure of the key players by making involvement more attractive and curtailing the scope for short-termist pressures on companies. Similar concerns have been expressed with regard to the potential effect of the UK Stewardship Code (Cheffins, 2010).

In parallel, the Review relies heavily on the concept of fiduciary duties to regulate the behaviour of all players in the equity chain, and highlights the need to impose an onerous duty of loyalty that exceeds the standards currently demanded by the regulators. Using the fiduciary duty of loyalty to regulate the relationships between parties to the equity investment chain is problematic on a series of grounds. Firstly, given the relevance of EU harmonisation in the area and hence the recommendation that EU authorities use fiduciary standards, there is the problem of difference in legal tradition between the UK and continental Europe. The concept of fiduciary duties, which emanates from equity, is distinct to English law and therefore is not suitable for adoption as a regulatory technique at an EU-wide level. Secondly, fiduciary duties are an ex post mechanism of accountability which relies on judicial enforcement. It follows that regulatory authorities are not the appropriate fora to develop fiduciary duties in the context of investment.

Third, the duty of loyalty, as exemplified in the context of company directors, is a duty to honestly promote the interests of another party, which precludes selfish behaviour, but does not prescribe any particular standard of care and skill (Companies Act 2006: 172(1); *Re Smith and Fawcett Ltd*, 1942; *Regentcrest plc v Cohen*, 2001; *Extrasure Travel Insurances Ltd*, 2003).

Mere incompetence or carelessness does not constitute a breach of fiduciary duties. This substantially limits the potential of the duty to regulate behaviour in the context of the investment industry, as asset managers can easily defend an action by asset holders unless there was compelling evidence of malpractice or dishonesty. A final problem is that it will often be a party further down in the equity chain who suffers from inappropriate behaviour, rather than the party to whom the duty of loyalty is owed. The main party whose behaviour the Review seeks to regulate by imposing a duty of loyalty are asset managers. However, inappropriate behaviour by asset managers is likely to harm the ultimate beneficiaries of the investment rather than the asset holders (e.g. to harm the employees rather than the pension fund). Since the duty of asset managers would be owed only to the asset holder and not directly to beneficiaries it would only be the former who could sue. This would make the private enforcement of the duty ineffective, as is the case in the context of director's duties (Reisberg, 2009).

6. Reforming Company Law and Corporate Governance to alleviate short-termism and its impact on UK companies

A. Introducing shareholder committees

A proposal discussed by Kay in his interim report, but abandoned in the final report in favour of an investors forum, was the introduction of shareholder committees, as a means to facilitate communication and collective action between the major institutional shareholders in each company (Stewardship Code: 3.16 – 3.17). The benefits of establishing such committees are potentially large in view of the need to foster effective monitoring and an ongoing dialogue between shareholders and directors. In addition, the introduction of shareholder committees where the largest institutional shareholders would be represented would, by itself, strengthen the position of long-term shareholders vis-à-vis short-term ones, since the former will have a steady representation in such committees. Such committees would also provide a forum for the discussion of the main corporate governance issues faced by each company and facilitate communication with the board of directors, as they would offer a visible point of contact and a cost-effective way to approach the main shareholders of each company.

Shareholder committees would also facilitate institutional involvement in the selection of directors as such committees would be able to oppose a nominated director that they consider to be inappropriate before the General Meeting. At present, major shareholders have to form a costly ad hoc coalition to be able to nominate directors. A shareholder committee would thus serve as a permanent institutionalised forum where such issues can be discussed and the actions of major shareholders can be co-ordinated. Furthermore, the increased role played by those shareholders who would participate in the committee would give an incentive to concentrate an adequate percentage of shares to ensure representation.

With regard to the practicalities of shareholder committees, they can be formed organically by those large shareholders interested in participating in them. This self-regulatory approach will provide adequate flexibility and dispense with the need for any formal procedure for the election of shareholder representatives.

B. Imposing an one year holding requirement to vote in general meetings

Another possible reform with regard to shareholder engagement would be the imposition of a requirement to hold shares for a period of one year before shareholders are able to vote in general meeting (The Takeover Panel, 2010). Subsequent to the takeover of Cadbury by Kraft Food Group Inc. it was proposed by several commentators that shareholders who buy

shares after a takeover offer is made public, are disenfranchised with respect to any decision to approve defences against the takeover. This reform proposal intended to curb the role of short-term arbitrageurs, such as hedge funds, who buy shares once a takeover offer is imminent and have no long-term interest in the company. However, the Takeover Panel rejected the proposal on the ground that it would undermine the principle of equal treatment of shareholders and be very difficult to implement.

Imposing a general one-year period requirement for shareholders to be able to vote could be implemented by an appropriate amendment of the Listing Rules which would require a relevant provision to be inserted in a public company's articles of association prior to being listed on the London Stock Exchange. The main benefit of such a reform would be the removal of incentives to purchase shares in order to vote on a particular occasion. In other words, it would ensure that only relatively long-term shareholders would be able to influence the corporate governance of major UK companies. A corollary benefit would be that awarding voting rights once shares have been held for a year would create an incentive for investors to hold shares for longer periods of time. This would by itself mitigate shareholder short-termism and encourage a constructive engagement of shareholders with companies.

The main difficulty with such a reform would be the probable opposition of institutional shareholders to what would be perceived as a curtailment of their rights. This could potentially increase UK companies' cost of capital. It follows that it would be necessary to obtain the support of a critical mass of institutional investors before going forward with such a reform. If this proves to be impossible, an alternative would be to introduce in the Corporate Governance Code a requirement for companies to consider issuing loyalty shares. Loyalty shares are shares that carry a special right, such as an option to purchase more shares at a favourable price, which can be exercised only if they are held by the same person for a period of time (Bolton & Samama, 2012).

Granted, imposing an annual holding requirement for shareholders to gain voting rights would undermine the principle of equality of treatment of shareholders, which is strongly embedded in UK corporate governance practice. However, rewarding long-term shareholders is necessary if we want to encourage commitment to companies and involvement and discourage excessive trading and short-termist pressures on companies. Indeed, the idea of distinguishing between desirable and undesirable types of activism and hence of shareholders was clearly accepted by Kay's interim report, but was not expressed as clearly in the final report (Kay, 2012: 3.13 – 3.15).

C. Setting an appropriate timeframe for directors' elections

Until 2010, the UK Corporate Governance Code (known then as the Combined Code on Corporate Governance) recommended that directors of listed companies stand for re-election by the shareholders at intervals of no more than three years (Provision A.7.1); unless they are non-executives who have served for nine years, in which case they were expected to stand for re-election annually (Provision A.7.2). However, currently the Code recommends that all directors of FTSE 350 companies stand for re-election annually (Provision B.7.1). The main rationale behind this reform was the enhancement of directors' accountability to the shareholders and the closer alignment of interests between the two groups. This recommendation is now followed by most major UK companies.

The problem with annual election is that it is likely to exacerbate the short-term approach followed by many boards to the detriment of the pursuit of long-term strategies. Introducing annual election adds further pressure on directors to focus on short-term profitability, as they will naturally want to ensure that they have some pleasant news to share with the shareholders at each annual general meeting. This may lead to a structural bias against long-term profit maximisation and therefore undermine the enlightened shareholder value approach envisaged by section 172 of the Companies Act 2006 (Keay, 2007). Annual election inevitably creates an incentive to focus on recent results and disrupts long-term planning and strategy formulation by boards. In addition, a year is a very short time period within which to assess long term strategies.

Annual election of directors is therefore problematic, as – to the extent that it influences directorial behaviour – it does so in a way inconsistent with the long term success of companies. I thus propose that directors should be recommended to stand for re-election every three years, as was the case until 2010.

D. Changing the structure of executive remuneration

It needs to be borne in mind that executive remuneration is a powerful incentive to ally the interests of corporate managers with the interests of shareholders. As such, it is one of the main viaducts by which short-termist pressures by shareholders influence decision-making by companies. There are two potential ways by which the incentives set by executive remuneration can lead to short-termism. First, the criteria used to assess performance and hence determine whether variable remuneration is to be awarded to a director may focus excessively on short-term profit maximisation. Second, the form of payment can be itself a cause of short-termism. For instance, paying executives in stock options or shares

creates a very strong incentive to increase the share price at the time the options or shares vest.

The Kay Review responded to the latter of these problems by requiring all variable remuneration to be paid in shares and that all the shares are retained by the executives at least until retirement from the company. To avoid inefficient incentives for executives to retire earlier, if they perceive that for some reason the value of a company's shares is going to decrease significantly in the near future, there should also be some restrictions in executives' capacity to sell their shares once they retire (Bebchuk & Fried, 2005). A limit of 20% of the shares they own per year would allow a retired executive to sell the whole of their shares 5 years after retirement and ensure that no perverse incentives to retire prematurely would influence executive directors and senior managers.

However, the Review remains silent with regard to the criteria used to assess corporate performance. Typically senior managers and executive directors have the opportunity to gain a bonus several times their salary and to be awarded shares under a so-called long-term incentive scheme on the achievement of certain performance conditions. These are usually focused on the comparative performance of the company with regard to a peer group of comparable companies, the main performance metrics being total shareholder return and earnings per share. The exclusive use of profitability metrics to assess corporate performance and hence to decide the level of variable remuneration managers receive exacerbates short-termism as managers face a strong financial incentive to follow policies that increase profits within the timeframe that corporate performance is assessed i.e. 1 to 3 years.

A possible reform in this area would be for the UK Corporate Governance Code to require companies to include some metrics that are not related to profitability. Non-financial criteria could include strengthening the reputation of the company, sound risk management, customer satisfaction, adherence to the company's values, and the absence of regulatory breaches. For instance, large UK banks are already required to include non-financial performance criteria in the assessment method of the performance of their executives (PRA and FCA Handbook: SYSC 19A.3.24). So, in order for a corporate executive to earn his variable pay he would have to balance financial with non-financial goals, and profitability with sound risk management. This could contribute to a broader change of culture in large UK companies in favour of long-term sustainability as opposed to a single-minded focus on short-term profitability.

7. Conclusions

This paper offered a critical analysis of the Kay Review and a broader discussion of the phenomenon of shareholder short-termism. It was argued that

shareholder passivity and shareholder short-termism are two interlinked phenomena, as meaningful involvement with companies is the main potential benefit of long-term investment, and therefore the main obstacles to shareholder involvement are at the same time factors that encourage very frequent trading and a short-termist approach.

Evidence confirms that the problem of short-termism is a serious one, especially in the context of the financial sector. In view of the deep-rooted causes of short-termism, it was argued that the recommendations made by the Kay Review are unlikely to prove adequate to foster a change of practice and culture of the relevant market players. Therefore, the possibility of reforming company law and corporate governance rules to tackle short-termism and create appropriate incentives for shareholders and corporate managers ought to be reconsidered. To this end, a series of reform options were explored, namely: introducing shareholder committees; changing the timeframe of directorial elections; imposing a one year holding period to vote in general meetings; and reforming executive remuneration design. Such reforms would be likely to reduce both the likelihood of short-termist shareholder pressures arising, and the susceptibility of corporate managers to succumb to such pressures.

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