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INVESTMENT MANAGEMENT

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Primary Markets Policy
Markets Policy Department
Financial Conduct Authority
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12 May 2017

Dear Sirs,

Review of the Effectiveness of Primary Markets

Hermes Investment Management provides active investment strategies and stewardship. Our goal is to help people invest better, retire better and create a better society for all. We have been doing this since 1983, initially to manage the assets of our owner, the BT Pension Scheme, and more recently for a growing range of external clients comprising £30.6 billion of assets under management and £264.2 billion of assets under advice (relating to our stewardship service)

Executive summary

We believe it is good practice to review the effectiveness of the UK's primary markets landscape in particular to ensure that market structures are not unintentionally impeding issuers in gaining access to the capital that they need to grow.

There is a trade-off between market fragmentation and competition which is amplified at the international level. In general however, we are of the view that the existing market structure is well understood and provides for a multitude of listing options for companies. The balance of interests between issuers and investors in the UK is sensible with increasing obligations on issuers as the pool of capital on offer through the relevant market segment becomes deeper. The UK's reputation for high standards has been well earned, should be proudly guarded and seen as an asset in terms of the competition for listings and capital.

More broadly, at Hermes we have long held the belief that the financial system should operate in the interests of its ultimate asset owners – the underlying savers – as opposed to its various agents. In recognition of this belief, we have noted that the quoted sector, larger companies in particular, rarely now look towards equity markets as their main source of capital raising. The ownership of shares therefore, we believe, should evolve so that it becomes the conduit for bringing about long-term sustainable prosperity for the entire system. This argument implies profound changes to the way that we as investors invest and in particular emphasises a greater responsibility to be good stewards than is currently recognised by investors today. We suggest that there are changes within the remit of the FCA that could be introduced in order to help markets better fulfil their purpose.

Yours sincerely,

Will Pomroy
Manager, Responsibility
Hermes Investment Management

The existing structure of the listing regime

At Hermes we offer a range of high active-share equity products managed by our teams of high conviction managers. A number of our investment teams, as well as our engagement team, have an interest (and significant experience) in the UK's equity markets with our spectrum of investments covering the largest companies in the FTSE 100 through to smaller companies listed on AIM.

It is our experience that the UK market structure is well understood by issuers and investors alike. It is right that small and fast growth companies are provided with flexibility and options in terms of how to come to market and raise capital with appropriate obligations. Equally it is right that larger companies are expected to adhere to the super-equivalent standards associated with the Premium segment and that a standard listing option is available for those companies that wish to list in the UK but do not wish to, for example, maintain a single class of shares. As investors we are cognisant of the different investor protections provided across the different UK market segments and these inform our judgement of risk.

We have noted the critique of the 'standard listing', in particular the suggestion that its name is a disincentive to issuers and the suggestion that accommodations should be made for overseas companies. The discussion paper questions whether the listing regime should be re-balanced in order that an international segment is created which provides more relaxed requirements for overseas companies than for domestic UK companies. The UK market has always been and remains very international in nature. Of the FTSE All-Share 16% of companies are domiciled overseas. Furthermore, many of the governance features which are typical in the UK have over recent years been exported to other markets and the debate over others such as dual-share structures remain live topics with investors increasingly voicing their discomfort where these structures exist. For these reasons we do not see merit in the proposition and believe that the same rules should be applicable to both domestic and overseas companies listing on the UK market.

The discussion paper notes that the number of traditional 'secondary listings' by large, established overseas companies is declining. It also recognises that few international issuers are seeking a standard listing because issuers overwhelmingly favour a Global Depositary Receipt (GDR) listing if they consider that a premium listing is not appropriate. Given that the mooted International Segment would not equate to a Premium listing and therefore presumably would not provide for index access, we are unclear what problem this new segment would resolve. From an investor's perspective, it would appear that the UK's existing structure is already providing issuers with plenty of options to access and raise capital which are utilised by overseas companies. In addition, we are able to gain access to overseas companies via a GDR listing and would likely not look any more favourably on a company which decided to seek a secondary listing as opposed to a GDR but instead listed in a newly created International Segment as opposed to the existing standard listing.

Scale-up capital

We agree with the assertion in the discussion paper that one characteristic of an effective primary equity market is providing a wide range of issuers with access to capital to fund their growth and development, to benefit the economy and society as a whole. To that end, it is right that, as a regulator, the FCA considers whether the regulatory structure of the UK's markets are impeding this objective, in particular with respect to scale-up capital for fast growth companies.

Broadly speaking we do not believe that primary market regulation is adversely impacting the effectiveness of the UK's public equity markets in providing scale-up capital. Instead the attractiveness of other markets, notably the US, for these companies is more attributable we believe to other factors such as the build-up of sectoral networks of expertise in these regions. We would point to the establishment of the High Growth Segment of the London Stock Exchange in 2013 as a clear example that flexible routes to market are available for these companies which allow for capital raising, exposure to investors and the time to transition towards the expectations of a Premium listing. To date, however, this segment has not proved popular with issuers.

We would contend that a UK listing provides a company with great credibility on the world stage. That the UK market is associated with the need for greater standards of corporate governance and financial management than in some markets should be seen as an asset to promote for those companies interested in their long-term success.

Patient capital / long-term capital market

The argument that the UK's equity markets fail to provide 'patient capital' is well rehearsed. While this is a debate that is too often clouded by mis-information there is a valid critique that the signals being received by companies from their investors are too often short-term in nature.

In our experience, the traditional long-only investors such as ourselves, continue to have a long-term focus and holding periods have remained pretty consistent. Self-evidently the market has become noisier and much more characterised by activity than it would once have been, however, in many cases much of the activity is driven by clients' flows and mandate restrictions than a fundamental shortening of investment time-horizons. That said, there is little doubt that a range of factors have driven more short-term thinking, in large part this is because this is the prism through which company and investor performance is measured, reported and discussed and as the old adage goes, what gets measured gets done.

We suggest that the drivers of much of what is described as short-termism are related to investor and market fragmentation, performance measurement and quarterly reporting with a particular focus on short-term metrics. While, we suggest that to a large extent the short-term signals are the result of market practices with many intermediaries incentivised to promote activity, rather than explicit regulation, we note below that there are steps the FCA could consider.

Short-term vs long-term

It is important to recognise in the first instance that equity capital in of itself is patient capital – the company is guaranteed the capital irrespective of whether the investor then sells the shares on the secondary market. That, for a vast range of reasons, there has been a significant flight from equity investing and equity capital raising over the past couple of decades is arguably the more important issue and warranting of consideration and potential intervention by government.

The widespread commentary on holding periods is often misleading as the headline numbers often misrepresent the reality painting a picture of rapid turnover of stocks. In practice we, and many other long-only investors continue to have reasonably lengthy holding periods while in-flows and out-flows of cash within funds from clients has increased the level of trading activity – this activity however, masks the true underlying holding period. To that end, greater transparency of an investor's objectives, approach and activity may be beneficial in helping companies and savers' understanding.

Benchmarks and investment mandates

It is important to recognise that for each of our investment teams their investible universe is broadly determined by the benchmark set for them by their clients in the mandates that they award. For our Global Small and Mid-Cap team, for example, their benchmark is the MSCI World Small Cap index. The benchmark index does not explicitly draw a distinction between whether a company has an AIM, Standard or Premium Listing – instead there are a number of eligibility criteria which encompass matters such as liquidity. Because of client restrictions it is the presence of a company within this benchmark has an important bearing on whether we are able to actively consider it for investment.

The industry's reliance upon measuring relative performance against a benchmark has embedded a focus on volatility and benchmark tracking error in the governance of the investment strategies deployed by managers on behalf of savers rather than a more intelligent long-term view which reflects the sustainability of real absolute returns. This issue is closely linked to the cited tensions with the provision of equity capital for companies at the smaller end of the market. Over recent years, in part due to regulatory pressures, asset owner's strategic capital allocations have shifted away from risk assets such as equities and where they have remained they have shifted towards global (rather than regional) equities, larger (rather than smaller) companies and from active towards passive mandates. The combination of these trends has created a particular squeeze for smaller domestic companies.

While market regulation may not, in large part, be the cause of the much short-term nature of markets, there are examples of well-intentioned regulations which unintentionally have resulted in the transmission of shorter-term signals along the ownership chain. The requirement for pension schemes to have a triennial actuarial valuation and the guidance from the Pensions Regulator that mandates and Investment Principles should be reviewed similarly on a triennial basis are two examples. The triennial valuations understandably focus the attention of asset owners on a much shorter time horizon than the length of their liabilities. Similarly, the mandate guidance has the effect of promoting a transactional rather than strategic or relational relationship between pension funds and their asset managers which promotes a focus on shorter-term investment performance, in particular in the period when mandates may be due for review.

It is important that any consideration of scale-up capital and assessment of the functioning of the capital market recognises that there are a multitude of signals being given at various points in the investment chain which have the effect of influencing an actor's behaviour. The FCA may be well positioned to facilitate or commission a review of the regulatory landscape to better understand where unintended short-term pressures and signals are arising.

<u>Quarterly reporting and purpose</u>

The discussion paper asks about the characteristics of capital markets that drive short-termism.

As long-term investors we put little weight in the information provided by a company's quarterly financial reporting, however, there is little doubt that this activity does result in increased market activity and has supported the growth of High Frequency Trading strategies and the decline in bank's market making activity. More importantly this frequency of reporting consumes a significant amount of management time which could no doubt be more productively spent.

There is substantial evidence which demonstrates that companies may reduce long-term investment if they fear that doing so will result in lower quarterly earnings. Similarly, evidence demonstrates a link between an increasing frequency of reporting and reduced investment and long-term operating performance. In recognition of this, it is encouraging to note more UK companies have withdrawn from issuing full quarterly reports, however, further encouragement in this direction could be beneficial.

The Purposeful Company's interim report and subsequent Policy Report presented substantial evidence that companies with a declared purpose, adhered to by their leadership teams and well understood by their stakeholders, perform better on key metrics over time than their less purposeful peers. Indeed, we believe that purposeful companies contribute meaningfully to human betterment and create long-term value for all stakeholders.

Practically, the longer it is before cash flows are expected to be generated from an investment the more they will be discounted by the market. High quality reporting on longer-term strategic issues and its relationships with different stakeholders is therefore of critical importance for investor understanding of a company's business model. In turn, a recognition and clear communication by a company of its purpose we believe is important in helping frame the conversation a company has with the market. If a company is confident about its purpose and subsequently clear about how it measures its success this will support and enable investors to focus on the fundamental drivers of its success.

Dual-class shares

The issue of dual-class shares is referenced within this discussion paper and floated as a proposal by the government within its recent Industrial Strategy green paper. We would like to take this opportunity to reiterate that there is rigorous evidence to demonstrate that dual-class shares, far from protecting entrepreneurial vision, in fact entrenches management (see Masulis, Wang and Xie, 2009). This manifests in higher levels of excessive pay, poorer investment decisions, bad acquisitions, and lower firm value. Pertinently, studies have showed that controlled companies with multiple share classes are associated with lower long-run stock performance, higher volatility and a higher likelihood of accounting irregularities (see IIRC 2012 study).

The relatively recent restriction on premium listed companies operating such a share class structure was enormously welcome and should be maintained. That companies are able to list on the Main market with a standard listing with a dual class share structure is entirely consistent with the risk profile of this segment of the market and investors are clear that they need to scrutinise such firms' governance more closely.

Moreover, the principle behind dual-class share structures is at odds with the agenda of democratising capital markets, giving voice to investors and embedding accountability along the length of the ownership chain. At a juncture when there is increasing recognition of the importance of stewardship in equity markets it is important to recognise that dual-class share structures significantly hinder precisely the sort of behaviour that is being encouraged, instead sheltering management from those to whom they should be accountable. We contend that proposing this measure is seeking to address a symptom rather than an underlying problem.

Market features of importance to long-term investors

The discussion paper notes that public equity markets provide different things and asks how important each of these are to long-term investors. The answer, unsurprisingly, is that each of those issues noted is important.

An important distinction recognised in the discussion paper is that between a long-term investor and an investor with a long-term focus. Our objective at Hermes is to deliver sustainable long-term returns for our clients. This necessitates a focus on understanding a company's fundamentals which requires appropriate disclosure of relevant long-term information by issuers. Similarly, it also requires confidence in the information provided and access to quality research on those companies to ensure a diversity of opinions and views. Finally, we need there to be sufficient liquidity in an asset to have the confidence that we can sell as well as the ability to buy into a stock. Indexation has also had enormous benefits in terms of providing greater rigour to measuring investment performance and enabling cheap access to market returns for a vast range of savers. However, it has also had the effect of limiting investible universes and causing investors' to fret about companies they don't own as much as those they do – this is one feature whose importance could be diluted.

We would like to use this response to expand on a few aspects in particular.

1. Corporate transparency

Information is the life blood of markets, the frequency, type and framing of this information will shape the way that capital markets operate. As we have noted above, too often quality disclosure is displaced by quantity.

In addition to those points we have noted above, it is worth highlighting that to date, voluntary initiatives have had limited impact in terms of eliciting the quality of environmental, social and governance data which we require in order to properly understand a company's operational performance and future prospects. This information remains too often, patchy, inconsistent and incomparable. Analysis of company disclosures demonstrates that basic quantifiable metrics remain rarely disclosed, although associated 'policies' may be. Without wishing to generate unnecessary additional reporting burdens we do believe that markets would benefit from a greater push, perhaps through the listing rules, for companies to be required to publish a core set of quantifiable ESG metrics.

Information provision is particularly important at IPO and to that end we are very supportive of the FCA's proposed reforms to the IPO process as set out in CP17/5 – these reforms have the potential to significantly improve earlier access to information and in particular independent research on companies which would be warmly welcomed by investors.

2. Executive pay

The arguments around executive pay are well rehearsed in the UK. the debates are able to occur because a positive feature of the UK market is the level of transparency that is provided on governance matters.

Hermes published a paper in November 2016 entitled Remuneration Principles: Clarifying Expectations. In this paper we highlight that the prevalent executive pay structures utilised across the UK market are associated with negative features and in particular we note that many long-term incentives schemes actually encourage short-term behaviour. In our paper we made the case for significant simplification and deleveraging of pay schemes with a greater focus on executive management making a material long-term investment in the company's shares. There is substantial evidence to demonstrate that a high level of equity ownership is correlated with improved company returns and innovation over the long-term.

3. Stewardship

Our CEO Saker Nusseibeh recently published a paper entitled the Why Question – see here – which explores the purpose of investment and argues that the 'why' of investment should dictate the 'how' to reconnect capital with its underlying purpose.

The above paper notes in particular that the quoted company sector no longer looks to equity markets as the main source of capital. In recognition of this trend, a core function of equity markets is control and the responsibility of investors needs to evolve from simple allocators of capital to its steward, with far broader responsibilities. Equity holdings should no longer be seen as a way to allocate capital, but rather, should be redefined as a method for owners to control the companies that determine their economic social destiny.

Reflecting on our own industry we believe that the asset management industry can benefit its customers – savers – taken as a whole, only to the extent that its activities improve the long-run performance of investee companies. Successful companies need to be supported by long-term orientated and engaged shareholders. To that end, investors should have a more explicit duty to be engaged owners of their investee companies that is currently the case in order to ensure that such duties are enacted on their behalf.

Conclusion

At Hermes we believe that, while our primary purpose is helping beneficiaries retire better by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial and consider the impact our decisions have on society, the environment and the wider world. It is in that context that we welcome the FCA's review of the effectiveness of UK Primary Markets and would encourage it to also broaden this purview to consider the purpose and effectiveness of the secondary market.

We believe that the UK's reputation for strong corporate governance standards is an asset to be guarded and that the multitude of listing options available presents issuers with a sensible degree of flexibility allowing suitable access to the equity markets for companies at different stages of development and from different jurisdictions. Importantly the distinctions and associated risk profiles are understood by investors.

We have noted in our response that we empathise with the frustrations expressed by companies with respect to the short-term pressures that they feel from investors. We believe that these pressures are real although are typically result of market practices, which have in part been the unintended result of well-meaning regulations. These practices have shortened the time-horizons of the various actors in the ownership chain. Regulatory intervention could prove helpful in dampening some of these signals and giving greater confidence to investors and companies to have a discussions around the fundamental drivers of corporate performance and allowing investors and their clients to focus on long-term absolute performance and real-outcomes.