CAD-02235

COMMITTEE
ON
THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

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25th February, 1992

Dick Taverne, Esq., QC,
Chairman,
PRIMA Europe Limited,
14, Soho Square,
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Dear Dick,

Many thanks for your letter and I was interested to see the range of people you had interviewed. I do understand the point you are making, but I believe that the institutions are reluctantly being forced to take the make-up of boards and the weight of the outside directors on them more seriously.

I fully appreciate Colin's comment, because I was infuriated, wearing my PRO NED hat, to hear a Scottish institutional investor claiming recently that they could not find good outside directors, when they have never even approached us. Of course, they cannot find them if they go about it in a thoroughly unprofessional way, relying on word of mouth and the old boy network.

The first point we need to persuade the institutions of is the importance of the chairman. Without a competent, independent chairman you will not have an effective board. I have an axe to grind because I have written a book on the chairman's role, but other than Hugh Parker's collected articles from The Director there is no other literature on this vital issue. This I think is evidence that the chairman's role is both widely underrated and often misunderstood.

Next comes the importance of the process by which outside directors are chosen. Unless this is purposeful and to an extent competitive, the make-up of the board will not be right and the independence of the outsiders will be undermined by patronage.

The last piece of structure is to ensure that properly constituted committees of the board are in place, above all audit, but also remuneration and nomination.

Process and structure can perfectly well be monitored by the institutions. What they find difficult is to assess the quality of management and of its strategy. They could easily put that right, if they employed one or two of the excellent executives who have retired at 55 and are looking for a useful role.

In my former company, the chairman, chief executive and finance director between them see all the major shareholders twice a year. Increasingly, major companies are moving in this direction. Since the issues which the institutions ought to be interested in are strategic, the insider problem is minimised. The back-up to this, in which the outside directors can play a lead role, is more disclosure and better financial reporting under the aegis of an effective audit committee.

In fact the ISC have gone partly down your route in recommending that "the non-executive directors should acknowledge a particular duty to monitor the performance of the Board as a whole, and to report to the shareholders if they are not satisfied ....".

What concerns me about this proposal is that it divides the board. One group of directors would have a different set of external reporting relationships from the rest. It also ignores the role of the chairman, which again is not fully understood by the institutions. The scepticism which greeted the ABI pronouncements which preceded the ISC document was due to so many of their own boards being allegedly no model for others to follow!

These I should say are my personal views rather than those of the Committee and I think the debate is an important one, so please keep up the pressure. On the credit side, the non-executives forced the showdown with Saunders, when all the institutions (except two Scottish ones) sat on their hands while Saunders was made chairman and chief executive in spite of the commitment to Sir Thomas Risk. Then Dennis Stevenson single-handed brought the Blue Arrow board to book, without any encouragement or assistance from the institutions, in fact rather the opposite.

The salvation I think will come when a new breed of institutional manager comes to the fore, not through the insurance route, and when the better analysts work for institutions rather than brokers. Both these changes are beginning to occur.

Where we are at one is that the present system is not working as well as it could or should, that the institutions should be encouraged to use their voice and the position of outside directors should be strengthened.

Yours Sincerely

Adrian.

Adrian Cadbury
Chairman

PRIMA
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POLICY RESEARCH · ISSUES MANAGEMENT

PRIMA E

Sir Adrian

I will gladly attempt a reply but would be grateful for a word first.

Nigel
17/2

6 February 1992

Sir Adrian Cadbury
PO Box 433
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Dear Adrian

Thank you for your letter of 30 January. The trouble in my view is that institutional shareholders all pay lip service to the importance of non-executive directors, but more or less ignore them in practice.

The people I interviewed were:- from industry: Sir Derek Birkin, Sir Trevor Holdsworth, Richard Giordano, Graham Mason and Judith Vincent of the CBI, Sir Patrick Sheehy and Brian Garraway; from the investment world, Mick Newmarch of the Prudential, Donald Brydon of the Institutional Shareholders' Committee, Andrew Threadgold of Postel, Mike Jones and Richard Regan of the ABI, Sir Martin Jacomb of BZW, the members of the Investment Committee of the NAPF, Robin Baillie of various Scottish Investment trusts and Peter Stormonth-Darling of Mercury Asset Management; and from other institutions:- Pen Kent and Jonathan Charkham of the Bank of England, Sir David Walker of the SIB, Colin St Johnstone of PRONED, Professor John Kay and Evan Davis of the London Business School, Professor Colin Mayer of the City University Business School and Hermann Niessen of DG XV in the European Commission.

It would be wrong to use attributed quotations, but it is worth repeating what was said. Very few of the investors had meetings with non-executives. None of them regarded non-executives as playing a major role in their own relationships with companies. If we want to intervene, said one, "we go direct to the Chief Executive or Finance Director". He was very sceptical of the knowledge non-executives had of their companies. An industrialist reported a chairman saying of one particular issue: "This is far too important to be left to the board". Several of the outsiders felt the whole basis of choosing non-executives was flawed - you wanted professional non-executive directors, not other company executives. Colin St Johnston (who I am sure would not mind being quoted) said non executives were "not visible to institutional investors".

Nowhere did I come across the view that non-executives were doing, or on their present performance were capable of doing, the job I believe they **should** do, as I argued in my Note - that is effectively performing the role of owners' representatives. Indeed I think it is highly significant that the ISC document you refer to talked about regular systematic contact between institutional investors and senior executives and never thought that there was a role in these contacts for non-executives. Yet, as board members, non-executives **ought** to be the people best placed to judge management's quality and the company's strategy. It confirms my view that institutional investors see the role of non-executives as quite useful in principle, but largely irrelevant in practice to the main task of ensuring the accountability of managers.

Yours sincerely

Dick

Dick Taverne

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30th January, 1992

Dick Taverne, Esq., QC,
Chairman,
PRIMA Europe Limited,
14, Soho Square,
LONDON, W1V 5FB.

Dear Dick,

Thank you very much for your note of 21st January, which I read with interest.

I agree with your analysis to a very large extent. Shareholders cannot be expected to have the detailed knowledge necessary to exercise completely effective control over managers' stewardship and in any case they do not want to be made insiders. In my view, they must rely heavily on the outside directors to look after their interests and ensure that the board as a whole remains effective. I agree very much that outside directors should have access to independent sources of information and should not be entirely dependent on the CEO. I am, however, slightly surprised by your finding that the major institutional investors regard outside directors as an irrelevance. I wonder if you are referring simply to cases where institutions have intervened.

Certainly the declared position of the institutional shareholders on our Committee is fully supportive of the role of non-executive directors. You may have seen that the Institutional Shareholders Committee (ISC) published a document last month on the Responsibilities of Institutional Shareholders in the UK. This recommends, among other things, that institutional investors should encourage regular systematic contact at senior executive level to exchange views and information on strategy, performance, Board membership and quality of management; and that institutional investors should take a positive interest in the composition of Boards of Directors, with particular reference to the appointment of a core of non-executives of appropriate calibre, experience and independence.

I accept that the ISC's recommendations for regular contact at senior executive level are not the same as your proposals for contact with the outside directors via an Investor Relations Committee, but they do, nevertheless, strike me as positive and helpful.

With best wishes,

Yours, Adrian

Adrian Cadbury

Spare for retention.

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Dear Adrian, 21.1.92

As I mentioned on the telephone, there was one specific point I wanted to make to your Committee. You suggested it was not too late, hence the enclosed note. I'd be happy to discuss it in person if you think it useful

With Compliments

Yours sincerely Dick.

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NOTE ON CORPORATE GOVERNANCE TO THE CADBURY COMMITTEE

FROM DICK TAVERNE, QC, CHAIRMAN OF PRIMA EUROPE

Enclosed is an article I wrote for the Economic Journal at the end of 1990. Its scope is somewhat wider than the subject matter of your enquiry, but I hope it will be useful background to this Note.

It makes three points that serve as the basic premises for the observations which follow: (i) the old relationship of owner/manager has been fundamentally changed by the spread of institutional shareholding; (ii) the continental and Japanese forms of accountability of management, with a closer relationship between managers and banks, have certain clear advantages over our form of accountablitity, which is in practice an indirect accountability through the discipline of the share price and the threat of takeover; but (iii) we would do better by seeking to improve the system we have and know, than by trying to transplant solutions from a different industrial culture.

1 A new relationship between owners and managers

In the light of the premises mentioned above, the aim should be to develop a closer, longer-term relationship between institutional owners and managers, in which managers are more effectively accountable and owners are more concerned to use their influence on management through "voice" than simply through "exit".

Both greater accountability of management and greater and more active concern by owners create problems.

(i) Problems of making managers more accountable

Managers are now to some extent accountable in practice as well as principle. They have clear duties of disclosure of certain information through the annual accounts. They are under legal obligations to disclose certain other kinds of information to shareholders when decisions are taken or certain events happen. And in practice failure to communicate information of importance to shareholders can lead to adverse public comment which will damage a company's share price (and therefore endanger managers' own careers).

But accountability depends on information. A more effective control over managers' stewardship of their companies depends on shareholders having a much more detailed knowledge of the way managers do their job than is strictly required by law. It depends on knowledge of the way they take business decisions, how well they handle people, how far they think strategically, how good their succession planning is and a host of other ways in which the performance of managers is or should be judged.

Some of these details may be known to banks which keep a close watch on their investment (as many continental, and few British, banks do). All of this information should in theory be known to the non-executive, or outside directors (ODs). But much of it is not known by institutional investors and sometimes would make those who have the knowledge insiders. Most institutional directors do not wish to be subject to the constraints of being insiders, or not all of the time, or only in relation to a limited number of companies.

In the real world of institutional ownership of British companies it is therefore unrealistic to expect effective direct accountability of managers to shareholders.

(ii) Problems about institutional shareholders exercising the full responsibilities of owners

Problems also exist in the way of requiring institutions to exercise the traditional role of of owners, that is ensuring that a company is properly managed, that employees are properly cared for, that changes are made in management before, rather than after, a company faces a serious crisis as a result of management shortcomings.

Since the real owners, or beneficiary owners, of companies have largely delegated their rights and obligations to fund managers, the question is whether fund managers are equipped to perform the traditional owners' role. The answer is: obviously not. They are not trained or not necessarily mentally equipped to second-guess management. That is not the skill for which they have been appointed. They will probably not have the time. As already mentioned they will probably not want to gather the detailed information they would need to perform such a role, because they do not wish to become insiders.

We cannot therefore expect a closer, more long term relationship between owners and managers, which is based on a direct relationship between institutional owners and management.

In practice those who can perform the supervisory role of the owners and to whom management should and could be effectively accountable, are the outside directors. It follows that the key to both a more effective accountability and a closer relationship between owners and managers lies in the way ODs discharge their task and in the relationship between ODs and institutional investors.

2 The effectiveness of Outside Directors

In general I do not believe it can be said that most ODs perform their task as effectively as they should. Where there have been corporate failures through bad management (MCC, Polly Peck, Brent Walker, or in much earlier days, EMI and Rolls-Royce, there has seldom been prior warning from ODs. When there has been anticipatory action to replace bad management, it has nearly always come from those (relatively few) institutions, of which the Prudential is an obvious example, who have been willing to use "voice".

Another indication of the general ineffectiveness of ODs is the fact that when institutions do intervene, or wish to discuss management changes, they tend to ignore the ODs. Recently I conducted an extensive survey for a PRIMA client of the attitude of major institutional investors towards corporate governance. While some said they occasionally talked to ODs, this was a rare exception. To most the ODs were an irrelevance.

Part of the ineffectiveness of many boards lies in the absence of independent sources of information by which the performance of managers can be judged. If ODs are entirely dependent on the CEO for their information, it is not surprising that they may not be made aware of facts which show management in a poor light. Anecdotal evidence tells one that most ODs think the companies on whose boards they serve are well managed and that their share price is undervalued! Most so-called independent directors are not in practice very independent of management.

What, however, could be the source of independent information? Most stockbroker circulars (although not all) do not contain the kind of detailed analysis of a company's performance and weaknesses which an effective supervisor of management would require. The answer , in my view, lies in the analyses provided by some of the larger institutional investors, the same kind of knowledge which sometimes makes them decide to change management or seek to influence the CEO to adopt a different approach.

3 A new form of Investors Relations Committee.

There have been many sensible recommendations for board committees in which ODs would play a prominent part: audit committees, remuneration committees, committees concerned with the appointment of new ODs, etc.

I would suggest that there should, as a general rule, be an Investor Relations committee of the board, which would not be the usual IR committee trying to improve the company's share price by putting on a road show that sells the company to investors, but a committee of ODs only, whose purpose would be to establish close relations between the major investors and the ODs.

One obvious immediate objection is that there would be a danger that such a committee would provide the major investors with inside information. This danger is very real. Some institutional investors, who do not intend to deal in a company's shares, are not afraid of being insiders, at least for a time. Others might not attend meetings with ODs if they thought there was any risk of inside information being divulged which would inhibit their dealing. ODs would therefore have to handle meetings of the board's IR committee with great care to make sure that the position of shareholders in general is not prejudiced.

However, the principal object of the meetings with institutions would not be a special report by the ODs to the investors, but an opportunity for the ODs to learn how outsiders saw their company. The ODs are the obvious people well placed to make good use of outside analysts' reports. (Good ODs are also in the best position to judge their value). Further, even if the company's major investors cannot always provide the kind of high quality analysis which some of the largest institutions produce, there is often a widely shared, shrewd assessment among major investors about which companies are well, and which are badly, run. Interestingly this outside view frequently fails to penetrate the boardroom.

The fact is that ODs are the best instrument for exercising "voice" on behalf of the institutions. At the same time the institutions are probably the best source of the independent information about a company which the ODs need. All that is missing in our present system of corporate governance is a means of bringing the two together.

Through a different kind of investor relations committee we could make the British system work better. In fact our system might then even acquire some of the advantages of the continental and Japanese systems of accountability, while at the same time we would preserve the advantage of a more open market which the other systems lack.

Dick Taverne 21. 1. 92