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Your Reference

Our Reference

Date

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30th July 1992

Nigel Peace Esq
Secretary
Committee on the Financial Aspects
of Corporate Governance
Chartered Accountants Hall
Moorgate Place
London EC2P 2BJ

Dear Mr Peace

"Cadbury" Committee Draft Report on
The Financial Aspects of Corporate Governance

On behalf of Lord Lane of Horsell, Sir Michael Craig-Cooper,
and myself I enclose a paper embodying the Commentary we have
prepared on the draft Report.

If it would be helpful for us to come to see you and/or
members of the Committee to discuss our paper, please let me
know and I will see what can be arranged.

I think it is right for me to add that we do not propose, at
this stage anyway, to release our Commentary to the press. We
think it right to give the Committee due time to consider what
we have had to say. We however reserve the right to do so at
an appropriate stage and in due course.

We hope the Committee finds our paper helpful, stimulating and
constructive.

I should be grateful if you would acknowledge to me the
receipt of our paper.

Yours sincerely

Nigel N. Graham Maw

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COMMENTARY

on

the Draft Report
dated 27 May 1992

issued for public comment by

THE COMMITTEE

ON

FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

by

Nigel N Graham Maw MA LLM (Cantab)
(Senior Partner of Rowe & Maw, Solicitors)

Lord Lane of Horsell
(formerly Senior Partner of
BDO Binder Hamlyn, Chartered Accountants)

Sir Michael Craig-Cooper
(Director of Carre Orban & Partners
International Management Consultants)

SECTION 1

Introduction: Background to the Commentators and to this Commentary

- 1.1 We, the Commentators named above, have for some months now, been working on the projected publication of a book to be entitled "Corporate Governance". The proposed publishers are Dartmouth Publishing Group and publication is planned for early 1993.
- 1.2 Our book will address the many facets of Corporate Governance on a broad basis. We shall deal with the legal and financial aspects but will by no means limit ourselves to these two.
- 1.3 As a result of our work on our book, we have already given a great deal of thought to our own approach to the subject, and we are pleased to see that many of our ideas and suggestions are echoed in the Draft Report as issued by the Committee. We would like to make it clear at the outset of this Commentary that there is a very great deal of material in the Draft Report with which we agree, which we welcome, and which we would endorse.
- 1.4 There are a number of respects, however, in which our own approach is at variance with the Draft Report and its Recommendations.

In addition there are a number of suggestions which we would propose but which the Draft Report does not raise.

The goal must be compliance with the best principles of Corporate Governance and we are not alone in having concluded that the Draft Report lacks the "stick and carrot" element to encourage achievement of that goal.

- 1.5 We hope that the Committee will find it helpful to consider our approach and our suggestions. Regrettably we have to acknowledge that some of our

criticisms may be found to be fundamental. They are, however, intended as a constructive approach in the general interests of the investing public, of financially interested parties, of the competitive position of British industry, of the high reputation of The London Stock Exchange, and of the shareholders/owners of those companies who enjoy the benefits and privileges of having a London listing.

- 1.6 We perceive that the Committee's "Code of Best Practice" lies at the heart of the whole Draft Report; we appreciate the difficulties the Committee must have experienced in preparing it, but we conclude that it is too imprecise and inadequate to serve as useful and effective a function as might be desired. We therefore propose our own "Code of Practice" and focus our criticisms in this Commentary on what we perceive to be shortcomings and inadequacies of the Code of Best Practice set forth in the Draft Report. Despite those perceptions on our part, we have adopted in our Code some of the suggestions contained in the Committee's Code of Best Practice.
- 1.7 As will be seen, we take a different and firmer approach, albeit also based upon a non-legislative system and monitored by The Stock Exchange as part of the Continuing Obligations (i.e. to be added to Section 5 of the Yellow Book) and to be adopted for new listings, so that eligibility for such a listing would be linked, additionally in the future, to the applicant company having adhered to (our) Code of Practice for at least two full accounting periods prior to listing. Suggested amendments to legislation are minimal, albeit important: they cover (as does the Committee) reducing the period for which Directors' Service Agreements can be entered into, and also (inter alia) acknowledging the distinction (established de facto but not de jure) between Executive and Non-Executive Directors ("NEDs"), and the possible introduction of a new provision (analogous to s.142 Companies Act 1985) to require the convening of an Extraordinary General Meeting to consider the situation where the mandatory provisions of the Code of Practice are being disregarded.

1.8 Whilst any new codified system of Corporate Governance should, we agree, be focussed on the constitution and activities of Boards of Directors, responsibilities must permeate lower down the management structure amongst all senior management and staff within the Group, particularly if the Group is large and diverse. Internal audit teams are, rightly, emphasised in the Draft Report. Reporting lines must be short, robust and responsive; monitoring and control systems must be effective, not only on the financial side; corporate ethics, training and education must be designed and tuned so as to achieve the objective that "Corporate Governance is nobody's exclusive preserve: it is a shared responsibility among us all". However, the buck must start and stop, at this early stage in the development of a Corporate Governance ethos, with the Board.

1.9 Our approach is, further and therefore, aimed at requiring Boards of Directors to have the right minimum proportions of NEDs and to conform with the mandatory requirements of our Code of Practice (and confirm they are doing so in the Annual Accounts by way of a Compliance Statement) if those Directors wish to continue to be eligible to serve on the Boards of listed public companies. **We do not consider that the sanction of suspension of dealings in the Company's shares bites where it should, except as a last resort: the potential loss of eligibility to be a Director of listed companies powerfully encourages compliance with (our) Code by the very people whose task it is to comply.**

SECTION 2

The Code of Practice

- 2.1 Our suggested Code of Practice is set out in Appendix A to this Commentary. We have deliberately eschewed the use of the word "Best", for it could be taken to suggest that something less than best will do. We would welcome (indeed it is fundamental to our approach) the Code being embodied in the Yellow Book, to become part of the Continuing Obligations of all listed companies with effect from as early a date as practicable. It is encouraging to read that The London Stock Exchange "intends to require such a [compliance] statement as one of its continuing listing obligations".
- 2.2 Further, we would suggest that if a Code is to have any teeth, then its mandatory provisions must be clear and precise.
- 2.3 We would agree with the Committee's suggestion that a London Stock Exchange requirement for a Compliance Statement (as to adherence to the Code) be included in Company Reports and Accounts in respect of financial periods ending after 31 December 1992. Clearly an additional transitional period must be allowed for compliance with the mandatory ("shall's" rather than "should's") fiats of our Code - perhaps a further year - before sanctions become operable.
- 2.4 As mentioned in the Introduction to this Commentary (Section 1 above), we take the firm and radical view that, after the expiry of that transitional period, if the Board of a London Stock Exchange Listed Company continues, without reasonable excuse, to disregard those mandatory fiats, then the Directors at fault should risk being disqualified (after a further, limited, period of grace) from serving as Directors of any London Stock Exchange Listed Company unless they can show cause why they should not be disqualified. It may be difficult to prove that only some of the Directors

are "at fault", and a procedure would have to be developed for ascertaining the main culprits, otherwise a Company might find itself, overnight as it were, without a Board of Directors. We concede that such a procedure is not without difficulties, but our idea (see below) for requiring an Extraordinary General Meeting to be held (the s.142 analogy) might help.

2.5 Whilst radical, this view is perhaps not as novel as may first appear.

2.5.1 We now have (since April 1992) Yellow Book (page 1.04) sanctions against Directors whose conduct is "such that in the opinion of the Stock Exchange the retention of office by him is prejudicial to the interests of investors". In that event "it will say so publicly; and if the director remains in office the Company's securities may be suspended and delisted". We would adopt that thinking for breaches of the Code, and go further with a general Stock Exchange (as opposed to legislative) disqualification for Directors in the first place.

2.5.2 We now also have the 1986 Directors Disqualification Act under which the Courts are already, in determining whether a Director is "unfit" within the meaning of that Act, deciding who is "fit", and thus laying down (albeit minimal) criteria for the positive attributes and abilities Directors should have. Hitherto Court cases on Directors' duties have been heavily influenced, by analogy with trustees, by the fiduciary (but negative) duties of Directors not to make off with the Company's assets or business opportunities and not to place themselves in a position of conflict as between duties as Director and personal interests.

2.5.3 We also have s.142 of the Companies Act 1985 (Duty of Directors on serious loss of capital) which calls for

the convening by Directors of an Extraordinary General Meeting "for the purpose of considering whether any, and if so what, steps should be taken to deal with the situation". Why not extend these requirements by analogy to situations where there is a persistent and unjustified failure by the Board of a listed company to comply with the mandatory provisions of the Code?

- 2.6 **So we suggest the main and primary thrust of the London Stock Exchange sanctions for non-compliance with the mandatory provisions of our Code should first lie against the Directors (which will hurt where it should hurt) rather than against the shareholders through the remedy of suspension, depriving them of the availability of a market for their shares.**

SECTION 3

Other relevant issues

- 3.1 The Draft Report suggests there should be a Nomination Committee. We see no necessity for there to be a separate Nomination Committee: we think the Remuneration Committee can fulfil the functions designed by the Committee to be administered by a Nomination Committee, since there will, inevitably, be occasions where a remuneration issue has impact on nomination issues. For example, a Company needs a new Marketing Director and finds an outstandingly suitable candidate, but he is only available at a salary greater than the Chief Executive!
- 3.2 We have always been troubled that English law knows of no distinction (as to duties, responsibilities, knowledge or deemed knowledge) as between Executive Directors on the one hand and NEDs on the other (except, perhaps, by implication, under the Disqualification Act and, to some extent, under the Insolvency Act). This is, we believe, a failure of the law to recognise what happens in fact and what will increasingly happen in fact if a mandatory requirement for NEDs on the Board is to be implemented as a result of the Draft Report or our own submissions.
- 3.3 As to disclosure of Directors' Emoluments, we see no reason why the Committee should have been so restrictive in its requirements. The Committee in effect has reflected the current law in saying that the emoluments of the Chairman and of the highest paid Director should be disclosed (plus the total emoluments of all directors) and (now further) that something should be said about the basis for performance-related remuneration. We cannot see any reason why the emoluments of each and every Director should not be set out in the Report and Accounts of every London Stock Exchange listed company. After all, we know precisely what top civil servants and judges are paid: details are in the Press. Why should Shareholders not know what each of their Directors is paid?

3.4 The Committee helpfully (and totally justifiably) says that NEDs can charge the Company with the reasonable costs of taking third party advice as to the performance of their functions as director. Whilst we think this is a very good idea, we wonder whether the Committee has considered deeply enough the problems of disclosure and confidentiality involved. We agree there must be some constraints and coordination (possibly through the NED Chairman or Deputy Chairman), otherwise taking third party advice might become an uncontrolled extravagance.

Consider this hypothetical situation. I am a director of X plc and I take the view that something is going wrong on which I wish to have my own second opinion and I, therefore, go off to see another solicitor, a barrister or a firm of chartered accountants or actuaries, not being the auditors or actuaries to the Company. I may not want the Company to know, when it reimburses me for the costs, whom I went to see, or what sort of advisor he was, or what I went to see him about. I would however be asking the Company to reimburse me for the costs, and, presumably, the Company would have to see that the expenditure was properly vouched for. Would it be sufficient for audit purposes for me to say that I had taken independent advice on a matter concerning the Company and the costs were £x and could I have a cheque please? Also, what about VAT? Moreover, if I am told there is in fact nothing to worry about, but I still want to have my expenses reimbursed, would I wish the Company to know at all that I had even been off anywhere to seek advice?

We think this is quite a serious dilemma, in theory, and do not know quite how it should be tackled.

3.5 We now have hallowed in statute law the concept of having ephemeral people around called shadow directors. How, we wonder, do they fit into the whole scenario of corporate governance? We see no easy solution here, but in the case of listed companies, there are typically no shadow directors

anyway: they "prowl and prowl around" in somewhat smaller entities.

- 3.6 We share the Committee's anxieties about the "going concern" basis. We agree that Directors should continue to be required to state in their Report that the business is a going concern. Already, by implication, auditors are required to confirm in their report that (as at the date of that report) the business was a going concern on the accounts date. If that were not the case they would be required to report specifically if the absence of such a going concern basis would affect the value of the assets or the liabilities. We are not convinced that any further extension of audit responsibilities would be productive or of value.

We believe that the Committee's recommendations at paragraph 5.23 go too far. If auditors decline to report (favourably) on the Directors' statement that the business is a going concern, the Company will assuredly not live long, even if otherwise it might have done.

As an alternative, consideration might be given to a requirement that the Directors' Report should state, specifically, whether, in their view, the Company's working capital was adequate as at the date the Accounts were signed off, with supporting assumptions or qualifications as necessary. The Auditors could be required to report on that statement, a task they are often called upon to perform in takeover situations.

We of course fully support 5.35 of your Draft Report.

DATED 30 JULY 1992

NIGEL N GRAHAM MAW
LANE OF HORSELL
MICHAEL CRAIG-COOPER

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APPENDIX A

CODE OF PRACTICE

to be adopted by the Boards of all companies
(domestic and foreign) with shares listed
on The London Stock Exchange ("Listed Companies")

1. The Constitution of the Board
 - 1.1 Each Listed Company shall have a minimum number of non-executive directors ("NEDs") on its Board. The minimum shall be one-third of the total number of directors, and the majority of the NEDs should be free of any other business or financial connection with the Company, apart from their shareholdings. If a Listed Company falls below that minimum (due to death, retirement, removal by the company in general meeting, or resignation) a reasonable time (not exceeding six months) should be given to fill the vacancy or vacancies.
 - 1.2 The Chairman should (preferably) be a NED and should not (preferably) also be chief executive or managing director. Where there are felt (by the Board after due consideration) to be good reasons for these preferences not to be adopted, one of the NEDs shall be appointed as Deputy Chairman.
 - 1.3 The NEDs should have the qualities of independence, objectivity and experience to enable them to evaluate the progress of the Company and the performance and ability of the Executive Directors, as well as to contribute in an informed and constructive way to board discussions. Whilst compliance with this Code is a matter for each and every Director, the NEDs have a particular role to play in monitoring such compliance.
 - 1.4 NEDs should typically be appointed for an initial term (subject to ratification by the Shareholders) of three years (four for the NED

Chairman or NED Deputy Chairman) renewable by the Company in General Meeting. Each NED should have a Letter of Appointment setting out his duties, his predicted time involvement, his fees, and the procedure for reimbursement of his expenses on legitimate company business, including travel to board meetings. They should not, as NEDs, be eligible to participate in the Company's pension or share option schemes, neither should their remuneration be performance-related. They should not be provided with a company car for their personal use. Their fees should be at a level not only to reflect their predicted time commitment, but also the level of responsibility undertaken, such level to have regard to the size of the Company concerned and the nature and extent of its activities. However the level of fees for an NED should not be so high as to jeopardise his independence.

- 1.5 NEDs should be selected through a formal process and their appointment must be a matter for all Directors. The selection process should be led by the NED Chairman or Deputy Chairman and primarily be conducted by the Remuneration Committee (see below). Appointments should, however, be a matter for the whole Board.
- 1.6 Service Agreements with Executive Directors must not exceed a fixed term of three years without prior shareholder approval. Rolling-notice Service Agreements, providing for more than twelve months notice of termination by the Company, must not be entered into without Shareholder approval.
- 1.7 Each Director must take out and maintain a "Directors and Officers" ("D&O") insurance policy. The Company should bear the costs of the premium, grossed up to take account of such payment being subject to Schedule E tax and National Insurance. The Chairman shall be responsible for monitoring compliance by each Director with this paragraph.

2. Board Committees

2.1 Each Listed Company shall (by Board resolution) set up and shall maintain:-

- (a) an Audit Committee; and
- (b) a Remuneration Committee

all the members of which shall be NEDs (including the Chairman, if himself a NED, otherwise the Deputy Chairman).

2.2 It shall be a major part of the task of the members of the Audit Committee to satisfy themselves as to

- systems of internal financial control,
- the adoption of appropriate accounting principles,
- compliance therewith,
- liaison with the Auditors as to their audit work,
- monitoring rotation (eg. every five years) of the audit partner,
- discussion with the auditors of all points of principle arising from their audit work including points to be raised in their management letter,
- recommending to the Board a fair and appropriate level of audit fees,
- verifying the nature, extent and costs of other (non-audit) work (eg. consultancy, taxation) carried out during the year under review by the Audit Firm.

The Audit Committee should be aware and keep under review the involvement of the Audit Firm in working for the Company on any consultancy matters.

2.3 It shall be a major part of the task of the Remuneration Committee to

- review the levels and bases for remuneration of the Executive Directors,
- negotiate and fix the terms of Service Agreements for Executive Directors and their severance payments,
- the levels of participation by Executive Directors in share option schemes,

- co-ordinate and manage (sometimes even to initiate) the selection process for promotions, recruitment and retirement of Executive Directors.

The Remuneration Committee should also, at least every three years, commission independent reports from suitable management consultants on Executive Director appraisals, as to the level of Executive Director remuneration packages, and the rates of NED fees.

3. Board meetings

- 3.1 Board meetings shall be held regularly (at least quarterly) on prearranged dates. Board papers shall (except in an emergency) be circulated in advance. Board Agendas should include a number of standard items (eg. financial results to date, cash flows - historical and projected, trading performance and prospects will be common to almost all companies) plus other relevant recurring items (determined by the nature of the Company's activities). Additionally, over the course of each financial year, each trading division or subsidiary should make a presentation to the Board, thus involving the attendance of divisional and subsidiary managers at Board Meetings.
- 3.2 NEDs should, individually, visit all major trading divisions or subsidiaries as soon as practicable after appointment and also periodically thereafter.
- 3.3 The objective must be to ensure that Board members have an understanding of the operation and financing of the Group and opportunities to evaluate and assess the effectiveness of Group Executive Directors and those to whom management functions are delegated by the Board. The Board should devise and adopt a regime for the division of executive responsibilities, and such regime should be kept under review and updated as and when appropriate in the light of changing circumstances. No one individual shall have delegated to him or her sole and unfettered powers of decision on any matter of a nature or exceeding an amount which shall be prescribed and adopted by the Board: such matters (the description of which will vary from company to company) shall only be proceeded with after and subject to the terms of Board approval.

4. Directors' Report and Annual Accounts

- 4.1 The Directors' Report accompanying the Annual Accounts shall contain a Compliance Statement as to the extent to which the requirements and recommendations of this Code have respectively been adopted and adhered to, with explanations as to the extent (if any) that they have not been. Such explanations should be given in sufficient detail for shareholders to understand and evaluate the reasons therefor, and shall contain a statement of future policy as to adoption of and adherence to such requirements and recommendations.
- 4.2 The Directors' Report (or, if preferred, a Note to the Accounts) shall fully disclose the emoluments of each and every Director (both Executive and Non-Executive) split into their salary and (for Executive Directors) performance-related elements. The basis on which performance is measured shall be explained.
- 4.3 Boards of Companies with pension funds must include in the Directors' Report a statement of their policy and attitude towards funding. There must also be included a statement as to the persons who are trustees of the funds, by whom they are administered and by whom the funds are invested. Any connection of any such persons with any Director or major (3% plus) shareholder in the Company must be disclosed.

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