IMC REGISTERED PRACTICE

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CAD-02415

28th July 1992

Mr Nigel Peace,
Secretary
Committee on the Financial Aspects of
Corporate Governance
P.O. Box 433
Moorgate Place
LONDON EC2P 2BJ

Sir Adrian

Do you have any wish to see Donald Butcher, or shall I plead pressure on your diary and offer to see him myself ?

Nigel

N.J.L 17/8

I will see him.

Adrian

Dear Mr Peace,

COMMENTS ON YOUR
ASSOCIATION (UKSA

I enclose with th
the UK Shareholde
report.

Appendix 'A' of t[illegible] Association. Being a member of the Association, I was asked to draft the document which, after considerable discussion, represents the views of some 30 private shareholders.

The increasing concern being expressed about corporate governance has stimulated renewed discussion on the role of the individual/private shareholder. We believe that this underlines the importance of establishing a truly representative, democratic and independent organisation such as UKSA. We have had recent meetings with a number of institutional shareholder organisations and support has been expressed for our aims and objectives. We intend to work closely in the future with these organisations.

Having regard to the fact that our Association aims to speak on behalf of an important group of private shareholders, we would very much appreciate the opportunity to present our views to your Committee and to discuss any of the issues raised. Perhaps you would be kind enough to let me know if and when this might be possible?

We very much hope that our comments will be seen as making a positive and constructive contribution to your Committee's work.

Yours sincerely,

Donald B Butcher

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LONDON EC2P 2BJ

Dear Mr Peace,

COMMENTS ON YOUR DRAFT REPORT BY UNITED KINGDOM SHAREHOLDERS' ASSOCIATION (UKSA)

I enclose with this letter a document containing the comments of the UK Shareholders' Association on your Committee's draft report.

Appendix 'A' of the document gives information about the new Association. Being a member of the Association, I was asked to draft the document which, after considerable discussion, represents the views of some 30 private shareholders.

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Yours sincerely,

Donald B Butcher

THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

(THE 'CADBURY' REPORT)

COMMENTS ON THE DRAFT 'CADBURY' REPORT

BY

UNITED KINGDOM SHAREHOLDERS' ASSOCIATION

27 JULY 1992

CONTENTS

INTRODUCTION

The Cadbury Committee's draft report on "The Financial Aspects of Corporate Governance" was issued on the 27 May 1992 and comments were requested by the 31 July 1992.

The United Kingdom Shareholders' Association's objectives are:-

1. To encourage, support and enable private shareholders in all feasible ways to discharge more effectively their ownership role in the companies of which they are members, given the present legal and regulatory system.

2. To advocate changes in the present legal and regulatory system where this would enable private shareholders to act in a way which improved the corporate governance of companies of which they are members.

The Association is in the process of formation and some further information is given in Appendix 'A'.

There is almost universal agreement as to the progressive decline in the standards of UK corporate governance, indeed that is the reason for appointing your Committee. There is also widespread agreement that one factor contributing to this decline is the absence of effective ownership. Both institutional and individual shareholders perceive many obstacles in the way of their performing effectively their ownership role.

We believe, therefore, that solutions should be sought in the direction of establishing more effective control by the owners of the board and of the auditors. The weight of your Committee's view is that more effective control will stem from more reporting and more information. Whilst we accept that benefits will flow from more information, we believe that much greater weight now needs to be given to making more effective use of the reporting and information presently provided by companies.

We, therefore, focus our comments primarily on issue iv of your Committee's Terms of Reference, namely:-

"the links between shareholders, boards and auditors"

SUMMARY OF PROPOSALS

We believe that the continuing decline in the standards of corporate governance does require urgent action. We do not believe that the entire responsibility for this decline lies with the boards of PLCs, albeit they must take the main share. Given that the law places ownership on the shareholders, they have a responsibility to act. It is the objective of this Association to assist individual shareholders, in a professional manner, to do so.

Given the need to act, we argue that the initial focus should be on improving the conduct of AGMs which should be reformed in order to provide a more effective conduit for members not only to make their views better known to the board but also to have their views make more impact on board decisions.

With the above in mind, we make the following five PROPOSALS which are supported by a brief argument in the main body of this document:-

1. The present restrictive requirements regarding members' resolutions to be changed, primarily in respect of number of members needed to sign and costs to be borne by the company (see section 2.2)

2. Resolutions regarding the remuneration of directors to be voted on at AGMs with disclosure matching the new regulations set by the US Securities & Exchange Commission (see section 2.2)

3. The status of questions at AGMs to be enhanced. Three classes of questions to be recognised - written, supplementary and oral - with agreed procedures. Minimum time of one hour to be devoted to questions. Members to have the right to put questions directly to the auditor and/or the Chairman of the Remuneration Committee (see section 2.3).

4. Two classes of non-executive directors to be created, one appointed by the board to contribute to the 'leadership' of the company, the other class appointed by members to contribute to the 'control' of the company. This reflects the distinction made in your Committee's report between the two roles of non-executive directors (see section 3.2).

5. Compulsory rotation of auditors to be adopted. Other proposals put to your committee, such as transferring audit sovereignty from members to independent trustees, to be further examined (see section 4).

1. 'BALANCE OF POWER' - THE KEY ISSUE

The draft report makes many references to "control" and "accountability" but nowhere does it address the root problem which has to do with where, *de facto* as as opposed to *de jure*, power lies. This point has been elegantly made in the David Hume Occasional Paper No. 23 (by Allen Sykes) in section 3, "Serious Flaws in Corporate Governance":-

> *"Most shareholders of public companies are at best passive owners leaving a massive power vacuum which non-executive directors, however capable, cannot fill satisfactorily".*

Overwhelming power lies with the board and this power dominates what your Committee describes as "the system by which companies are run". In this 'system' it is the board which effectively:-

* appoints the executive directors
* appoints the non-executive directors
* appoints the auditors and decides their remuneration
* decides its own remuneration package or, in some cases as your Committee recommends, appoints a remuneration committee to make such decisions.

An indication of your Committee's acceptance of the board's power can be seen in its recommended Code of Best Practice. No reference in this code is made to section 6 of your report which deals with the shareholders. The Code has 19 sections of which 17 refer to that part of your Committee's report (section 4) which deals just with the board. The remaining two sections of the Code refer to auditing which is dealt with in section 5 of your report.

We contend that without some measures to shift the balance of power more towards the owners, corporate governance will not significantly improve. Your Committee's Code attempts only to change the "balance of power" within the board so that "no one individual has unfettered powers of decision" (paragraph 1.2 in the Code).

However, even given the present unsatisfactory position, we believe that there is scope for enabling shareholders to become more effective owners and this is the objective which the Association has set itself.

2. CONDUCT OF ANNUAL GENERAL MEETINGS

2.1 Effectiveness of AGMs

We AGREE with your Committee's view stated in paragraph 6.5 that "both shareholders and boards of directors should consider how the effectiveness of general meetings could be increased and as a result the accountability of boards to all their shareholders strengthened". Regrettably the conduct of AGMs has fallen into such disrepute that, without a major change in the system, progress in the direction which your Committee says is desirable will be so slow as to be imperceptible. We, therefore, DISAGREE with your Committee's findings stated in paragraph 6.3 that "the accountability of boards to shareholders will be strengthened if shareholders require their companies to comply with the code". We contend that a great deal more than this will be required.

For example, the above mentioned Hume Paper provides the most telling critique of the typical AGM from one who has served as a director of major PLCs for many years:-

> *"In my experience of British public company AGMs, what I first noticed thirty years ago has changed little in substance since. The boards of public companies are not held to serious account at AGMs, nor at the rare and usually unrepresentative private meetings with institutional shareholders. In sum, they are not in practice accountable to their shareholders at all save in occasional crises. This has profound effects for the pressures (or rather lack of them) for optimal efficiency to which boards are supposed to be exposed."*

These same words will be just as applicable in another thirty years unless significant changes are made now.

We believe that it is an urgent necessity in the interests of both boards of directors and shareholders to focus primarily on practical ways by which AGMs can be made more effective. The meetings need to be energised, to be democratised so that they become an arena in which meaningful things are said and decided. They have to cease to be the non-eventful, boring, rubber-stamping process which mostly they presently are. Unsurprisingly as presently conducted, AGMs do not attract many serious committed shareholders who resent wasting their time in such seemingly useless events.

We believe that progress will best be achieved by focusing on just two aspects of the AGM - resolutions and questions. The first will need action by government in changing company law, the second will need action by shareholders which will be assisted by the work of this Association.

2.2 Resolutions

We PROPOSE that:-

* changes should be made in the present required procedures for members' resolutions and voting thereon, and

* one additional mandatory resolution regarding board remuneration should be introduced.

Members' resolutions

The present procedures required by Section 376 of the Companies Act are far too restrictive and militate severely against members taking an active ownership role. Changes should be:-

* number of members required to requisition resolutions to be reduced from 100 to 10.

* circulation of the resolution should be at the company's expense, not the requisitionists.

* voting by a show of hands of all members, or their legal representatives, attending the meeting to be attested by, say, the registrar of the company.

* in the case of those resolutions which have been passed, the company shall notify all members in writing within three months what action the company is taking or otherwise call an EGM

* at the next AGM, the company to report on the action taken and the progress made against each resolution which has been passed.

The above outlines the kind of principles which should apply, it not being within the scope of this document to provide a legal draft.

Resolutions regarding board remuneration

We PROPOSE that resolutions regarding the remuneration of directors should be subject to voting at AGMs by those members, or their properly authorised representatives, who are present at the meeting.

This will necessarily require much more disclosure of information concerning directors' remuneration packages. The US Securities and Exchange Commission's new regulations which require remuneration packages to be broken down into a table of nine separate components would no doubt provide a good model.

2.3 Questions

Questions, if sensibly handled, could make a much more

valuable contribution to more open corporate governance. The aim should be to improve the status of questions without restraining their effectiveness by too much formality. For this reason we are seriously concerned about your Committee's recommendation regarding written questions since it seems to suggest that all questions might well be handled in this way. We comment further on this point below.

With the aim, therefore, of improving the status of questions we PROPOSE that new procedures should be agreed between companies and members for handling three defined classes of questions:-

* written

* supplementary, and

* oral

Typical procedures would be as follows:-

* A minimum of one hour should be established for questions to be answered.

* Typically one half of this time could be devoted to answers to written questions with members who attend the AGM having the right to ask a supplementary question on the answers given to their own written question.

* Any member's question specifically addressed to the Auditor or the Chairman of the Remuneration Committee should be answered by those persons. All other questions to be answered by the Chairman or one of his directors if he so wishes.

As mentioned above, your Committee's recommendation regarding written questions (paragraph 6.5) may result in the demise of oral questions. Written questions can seriously detract from the value which can come from the spontaneity and human interaction which are one important feature of the AGM. We contend that more meaningful information regarding the effectiveness of the board can be gleaned from the way that questions are handled at AGMs than all the carefully prepared and somewhat 'sanitised' information often contained in annual reports. Your Committee's suggestion could well reinforce the already regrettable tendency for AGMs to be totally 'stage-managed' depriving the meeting of any remaining value from the members' point of view. We have attended one such meeting with written questions submitted in advance. This reduced the meeting to a quasi second-rate theatrical occasion. Directors by and large do not make particularly convincing actors especially when handed a poor script.

Establishing new procedures for questions will need action by members. Our Association sees as one of its important tasks the improvement of members' ability to draft effective questions about the information conveyed to them in the annual report.

2.4 Arguments against our proposals

Some will argue that our proposals may make meetings vulnerable to unrepresentative groups wasting management time dealing with their resolutions and written questions. If any meaningful attenpt is to be made to improve corporate governance by making AGMs more effective, then this is risk which has to be taken. We believe that the good sense of the great majority of members will prevail. Indeed the awareness of this risk will be one factor which should assist in mobilising members to perform their ownership role more effectively.

3. ROLE OF NON-EXECUTIVE DIRECTORS

We first touch on the acknowledged defects in the present system and then make proposals for change. The defects arise from the fact that non-executive director appointments are made solely by the board and by the fact that they are expected to fulfil two conflicting roles - and, as some argue, for a modest remuneration at odds with the responsibilities assumed.

3.1 Defects in the present system

Control versus leadership

We DISAGREE with your Committee's view put forward in paragraph 4.7 that non-executive directors can exercise successfully both their "control" function *and* make their "primary and positive contribution ..... to the leadership of the company". This is seen to be largely unachieveable in practice - with very rare exceptions. However, understanding these two conflicting roles suggests the solution which many have proposed and which we support.

Remuneration committees

We AGREE with your Committee's view stated in paragraoh 4.36 that "shareholders require that the remuneration of directors should be both fair and competitive" but we DISAGREE with your Committee's view stated in paragraph 4.34 that remuneration committees "consisting wholly or mainly of non-executive directors", all appointed by the board, will achieve this objective.

Since your Committee's report was issued a detailed study conducted by Professor Main of Edinburgh University has concluded, after finding that average chief executive remunerations were some 24 percent higher in those companies which had established remuneration committees, that:-

> *"Merely setting up a remuneration committee is no answer to the problem of controlling top executive pay"*

The study further concluded that:-

> *"There is clear scope for greater shareholder activism, both in demanding greater disclosure of the nature of the deliberations of the committees and by securing non-executive directorships for shareholder representatives".*

3.2 Two classes of non-executive directors

Having regard to the two conflicting roles which have been highlighted by many critics, we PROPOSE that there should be two classes of non-executive directors, one class appointed as presently by the board whose main contribution would lie in the direction of the 'leadership of the company', and the other class, appointed by members, whose main contribution would be the 'control' function.

We further PROPOSE that fifty percent of the non-executive directors should be board-appointed and fifty percent member-appointed.

The procedures for appointing and supporting these member-appointed non-executive directors would need careful design and fall outside the scope of this document. By virtue of their resources and large shareholding, we would expect the institutional shareholders to take the main initiative in this regard. We are nevertheless eager to work together with institutional shareholder representatives in order to achieve a successful outcome.

4. ROLE OF AUDITORS

We AGREE with your Committee's view stated in paragraph 5.3 that "although the shareholders formally appoint the auditors, and the audit is carried out in their interests, the shareholders have no effective say in the audit negotiation and have no direct link with the auditors".

The defects in the present system were described in the submission to you by Merrett and Sykes as following from the fact that:-

> *"de facto audit sovereignty is in the wrong hands, namely that of the incumbent management"*

We believe that the present unsatisfactory nature of the auditing system is exemplified by the complexity which now surrounds the auditors' liability post Caparo. Over five pages of text in Appendix 4 of your Committee's report is devoted to this one issue. We DISAGREE with the your Committee's view that the solution to this problem lies primarily in the direction of "more effective accounting standards" (paragraph 5.8) but we AGREE with the committee's view that there are real difficulties in finding a "practicable way of establishing a direct link between the shareholders and the auditors" (paragraph 5.3). However, one practicable solution to this problem, we believe, lies in the establishment of 'shareholder consultative committees'. A procedure for establishing such committees has been proposed to your Committee by Dr Maurice Gillibrand and we believe this has considerable merit.

Your Committee's report discusses the compulsory rotation of audit firms in section 5.12 but rejects it. Our view is that compulsory rotation of audit firms would materially improve the present situation and we strongly support such a proposal. Further improvement could come from our proposal that auditors answer members' questions at AGMs.

A number of other solutions have been proposed by other parties. One proposal which we find persuasive is that the power to appoint, remunerate and direct auditors should be transferred from shareholders to independent trustees. Your Committee has received a detailed submission on how such a system would work, namely "Transferring Audit Sovereignty to Independent Trustees" by A.J. Merrett and Allen Sykes. No doubt other institutions might merit examination for this role.

APPENDIX 'A' - UNITED KINGDOM SHAREHOLDERS' ASSOCIATION

The Association presently operates as an unincorporated body having some 30 or so members who have contributed to its initial work. The Association intends to become a company limited by guarantee with charitable status possibly following in due course. It has prepared draft memorandum and articles of association which are under discussion by its members. The Association will seek to attract members primarily from the constituency of some 10 million plus individual private shareholders.

Aimed at serving the interests of private shareholders, particularly in performing their ownership role, the Association intends to adopt two guiding principles regarding its method of operation:-

* to govern itself in a democratic way, and

* to act in a professional manner.

The Association believes that both the governance and achievements of the Consumer's Association provide a good and challenging model for its own conduct.

In pursuing its objectives the Association will have the overall aim of improving the performance of companies which the Association believes will come from improved corporate governance. Such improvements will benefit the nation and all stakeholders - customers, employees and shareholders.