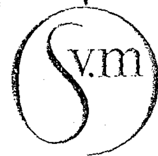
Scottish Value Management



23 July 1992

Nigel Peace Esq
Secretary
Committee on The Financial Aspects of
Corporate Governance
P O Box 433
Moorgate Place
LONDON EC2P 2BJ

Dear Mr Peace

I write as an institutional investment manager with comments on the Draft Report of the Committee on the Financial Aspects of Corporate Governance. We were particularly pleased to see the Report raise a number of issues, and suggest practical remedies - particularly as one of our clients, Scottish Value Trust plc, has identified a number of governance problems in listed companies in the course of its activities.

The enclosed articles cover some of our views. In particular, I enclose a presentation I made at a Stock Exchange seminar immediately prior to the publication of the report and an article published last week by the London Evening Standard. However, I will summarise our main concerns within this letter.

Our experience has been drawn from close inspection of a number of companies with which we have been involved; including Ensign Trust plc, Drayton Consolidated Trust plc, Harland Simon Group plc and Govett Strategic Investment Trust plc. However, our research has identified a number of substantial public companies in other sectors with the same underlying conflicts.

The Companies Act requires disclosure of material transactions connected with directors, but this definition is widely interpreted. Some companies are very frank in stating even relatively minor transactions or conflicts. However, transactions which are not considered material, and ongoing conflicts which do not involve a transaction during the year, need not appear in the annual report & accounts. Yet, even a small involvement by directors can be material *to the director* - at least sufficiently enough to risk accusations that it would bias a decision - whilst not being in any way significant to a large listed company. We believe that many non-executive directors have compromised their independence in this way and left themselves open to accusations of lack of independence.

The problem is outlined in the Evening Standard article and the talk. What is needed is a set of principles or rules within each company - and preferably encouraged by a report such as yours - to govern financial benefits for directors that do not flow directly from a parent company. It would specify how those are to be disclosed in its accounts. For some, this will involve specifying that 2

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investment by directors or managers alongside the parent company's investment can only be made if it is the same absolute or proportionate amount, or possibly only in specific situations. Other than in certain venture capital companies which apply strict rules, there appears little justification for co-investment in any event. Most investors wish to see board's and management's financial interest closely aligned with their own - and incentivised to the progress of the parent vehicle or group as a whole. This code of conduct must be implemented and supervised by the audit committee - with the exclusion of directors who have conflicts. If not, there is a risk that apparently independent directors on an audit committee can be involved in making decisions on principles on which they themselves are compromised.

The conflict can be particularly acute where further finance is required (Ensign and Drayton Consolidated Trust) and without such support the individual director might face a significant personal loss on an investment. We believe that some investments made by Ensign and Drayton Consolidated Trust highlight this risk. However, there are many other public companies (eg Dawson International) where an individual director of the parent company - whether executive or non-executive - is drawing additional undisclosed benefit (either through the form of remuneration, dividend or capital appreciation), from an investment that may well not be a subsidiary undertaking. This threatens the integrity of the board and calls into question the independence of the audit committee.

In summary, we believe disclosure is the right way to deal with this. We would like all main board directors to state any financial benefit they receive from all undertakings in which the parent company has made an investment. If all benefits are paid to the main company and there is no co-investment, then nothing further need be stated. The disclosures should cover fees received by directors who are partners in professional firms and, possibly, even a simple statement that X director is also a director of Y company which is a customer or supplier. That would not need financial quantification but would make the relationship clear for all to see.

We believe that a workable solution could be produced which would deal with the issue. Whilst companies may claim that it involves the disclosure of much minutiae, that itself simply encourages them not to enter into further complications of this type and thus simplify their disclosure.

I would be pleased to provide further examples and detail if required but hope that you can take account of this submission within the final report.

Yours sincerely

Colin W McLean
Managing Director

THE STOCK EXCHANGE AND ITS CUSTOMERS IN THE 1990s

Holiday Inn, Glasgow - 28 MAY 1992

The Fund Manager's Perspective
Colin W McLean, Managing Director of Scottish Value Management

I appreciate the risk that the Chairman is taking here today in inviting me to speak. For my perspective on the Stock Exchange is not just that of an institutional investment manager, - I have also seen the other side of the Stock Exchange. While Scottish Value Trust is today a £15m authorised investment trust, it emerged as one of the very few companies to make it back from the land of the living dead that is called suspension from listing. So vivid are the memories that so many, especially here in Glasgow, have of this predecessor company, that even now I hesitate before repeating its name - Bremner.

Bremner must truly have been a vexatious issue for the Stock Exchange - as, indeed, it was for the entire Scottish financial community. Long after its illustrious past as a department store - and it was merely one of three department stores in the recent past to run into problems - Bremner catapulted itself into a 1980s style of aspiring financial institution - even owning a stockbroker at one point. But as many directors will know, where board room discussion over minor items such as purchase of paintings can take longer than other strategic issues - emotion is often disproportionate to the size of the issue. For a small company, Bremner had plenty of emotion. But unlike other companies where the Stock Exchange intervenes, mere suspension from listing from time to time did not drive the stake through the heart that usually happens. I can imagine to the Stock Exchange at the time, Bremner must have resembled something like Cape Fear in slow motion - with Robert De Niro in the role of Bremner.

I think a few more years will have to go by before a deeper public exposure can be given to all that was involved. But my general impressions were that the Stock Exchange did prove very helpful - they made their requirements very clear and responded in a very practical way, albeit without favour. I don't think any company in a similar position could ask for more. The problems in such a situation are really to do with the Companies Act and the general legal framework. For companies can easily deteriorate to a position where it is very difficult to attract new directors - even company doctors - without legal cover. And insurance is impossible to secure at such a time.

Moreover, directors' usual duty of care becomes magnified under the spotlight of the threat of further litigation. Legal views can be obtained - but we all know that they can also differ. Even the same counsel's opinion can substantially alter from one day to the next. And, legal and other professional views are, of course, not commercial views. Ultimately a board must make a commercial decision - balancing legal assessments, other professional opinions and opportunity costs, as well as the risks involved in all of these. For that board decision, there can be no legal or insurance protection. So, it is unfortunate that, where there is no major institutional or family investor in a company in a position to deliver a long dated proxy and call in a company doctor, these external legal pressures can spiral a company into collapse - even where it has ample cash balances.

The end of the Bremner story, however, was a happy one. There proved, throughout a period spanning just over a year, to be a majority of shareholders with the Company's interests at heart, and the eventual resolution could not have been achieved without their considerable and continuing support. What they got was a resumption of listing, an active market with three market makers and a total return over 10 months and 3 days of 40%.

My message on this, to institutional investors as much to the Stock Exchange, is that litigation is always present with commercial trading companies, listed or unlisted. Unless it is deemed material by a company board, it need never appear on the balance sheet. Dealing with it is, however, a matter on which audit committees should have a strong voice - if not total control. And listed companies are, unfortunately, even more handicapped by threats of litigation and more vulnerable given their greater degree of disclosure. The press' willingness to publicise these - and there have been several

large public companies recently the victim of public threats of litigation on a wide range of matters - suggest that all of us - both company directors and the Stock Exchange will have to become more familiar with the implications of different types of legal action and make robust commercial decisions.

The challenge for the Stock Exchange with problem companies or boards, is that the main sanction will always be the threat of suspension from listing. Anything that seems likely immediately to write-off a quarter of a company's value, representing the usual discount of private companies, will always look like shooting oneself in the foot. Knowing the reluctance to take this serious move, there will be companies that attempt brinkmanship. And there is a danger that the timing of Stock Exchange action can appear to proximate its conclusion on the wrong event, or even on a particular specific event - despite being what is no more than the last straw in a long series. I do think that, when a second warning is given on breaches of the listing agreement, it should be made public.

The Stock Exchange not only deserves credit for this result, and listing Scottish Value Trust, but also for a system which in general has produced a market that is very deep and liquid. I think most institutional investors, particularly where they look at what happens in other countries, would accept the present position as being much better than most, and an improvement on the past - even if not ideal.

I welcome the forthcoming Stock Exchange review of market making and conflicts within houses that make markets in equities and derivatives. As regards the extent to which firms capture business without the cost of deploying capital by using other market makers' prices, I am not sure that I accept that argument. I do think that the market mechanism will price these services correctly - provided there is adequate exposure, the appropriate risks should be priced in. If it cannot be, that just represents the effect of market forces, and I do not think that the centre of our market-led economy should ever attempt to restrict trade between participants.

Institutional investors are also watching the Stock Exchange, as it restructures its capital to pay for the technology it will require to become both an efficient administrator and, possibly, a regulator. Where companies must protect individual rights of members and shareholders, they look to the Stock Exchange to set a lead in practice. It may prove difficult ultimately to protect shareholders' rights in general - particularly against modern notions that share ownership is more of a leasehold interest than true freehold - if Stock Exchange private members' rights are changed without visibly being approved by those members. Even in public companies, non-voting shares have protected rights and usually have some influence on any attempts to change the overall structure.

I do think that institutional shareholders see the market overall becoming very market maker led - and research and provision of information are gradually becoming a commodity and adding less value. This is not because of the failure of research, but rather a result of success - as research standards have fairly uniformly risen to the point at which it becomes more of a commodity. However, I think the restructuring for the 1990s is not just about being quote driven or order driven, but about institutions themselves reconfiguring to match the liquidity available. A greater proportion of indexation will reduce the size of their actively managed funds, to a level at which they can participate in the true pricing anomalies that remain. Investment trusts too, will I feel play an increasing role in this - for example in offering a liquid exposure to smaller companies.

Institutional investors do, I believe, want to preserve positive aspects of the present system; the rights issue process being one, although I do not necessarily think this means that underwriting fees need not be negotiable. These fees represent the true cost of equity, for there can be no other definition of equity having a cost, insofar as it represents ownership and entitlement to greater rewards than just dividends. The discount at issue is not a net benefit to anyone - being just an element of scrip that is conferred on the existing owners of the business, not new subscribers.

The key to diversification of private shareholder portfolios must be investment trusts, PEPs and low dealing charges. Bought deals, which would replace rights issues, have every incentive to minimise risk by selling on quickly to institutional investors. Time is at a premium and there is no incentive to distribute to private investors. It would undoubtedly produce narrower share ownership. If pre-emption rights were undermined, shares would no longer be shares, and questions of wider and

deeper ownership would be academic. Ownership of just what would they represent, without rights? I would urge the Stock Exchange to maintain its adherence to the pre-emption rights principle.

A healthy new issue market is also to be encouraged, although I would like to see our prospectuses raised to even higher standards. The inability of investors to identify organic growth within a company that is being demerged and listed - where considerable assistance has been given by the parent over the years - is unsatisfactory. A past record can only be meaningful if the growth history is directly relevant to the issued form of the company. Investors would like to see improvement here.

One other concern I have is in takeovers, in that I do not believe that companies should be allowed to value an offer without applying a discount if the shares to be issued are not identical with those already being traded. This practice removes arbitrage and destroys market influence. If companies making an offer wish to remove certain types of arbitrage, one should really question whether they accept the value of the listing and the price the market sets. But where they wish to issue shares with different rights, it should be made quite clear that the value of the offer should be appropriately adjusted to reflect that.

I think there is also a need for clarification of just what the close season implies - that is restrictions on directors' and associates' dealings rather than on the timing of release of information. Some of the recent spectacular surprises have arisen from misunderstandings about what can be said before results. However, there are many things that should properly be publicised immediately - either because they do not involve a profit forecast or they are sufficiently material to make it essential to avoid any possibility of a false market developing, or accusations of fraud being made. Institutional investors do get the impression that a number of companies are not following the basic principles on disclosure, using the excuse of proximity to results.

There is one other serious issue that I would like to raise before I finish. That is potential conflicts of interest and disclosure of these.

All involved in the securities industry have worked hard over the past decade to align the interests of management with the owners of the business. This, in general, has been achieved by incentive arrangements and share option schemes. Some of the most successful companies are ones where there is a significant financial interest of the board in that company and growth has been largely organic - and therefore not diluting that interest over time as the company expands. There has also been improved corporate governance - with audit committees reviewing most matters, such as salaries and employment contracts that pose potential conflicts. However, there is a broad area which still unfortunately does not require disclosure - and which even the Cadbury Report does not fully address.

This is, where directors have interests in contracts, which the company or subsidiary undertakings are party to, which may be beneficial but are not material. Clearly they must already be disclosed if they are material.

Institutions are becoming much less happy about transactions between a company and associated interests of any directors. And, there is an unfortunate tendency to describe in prospectuses as "independent" anyone who is not actually employed by the company. By doing so, those who are consultants to the company, professional advisers or retired employees can all be viewed incorrectly as always having exactly the same influence and interests as those who are genuinely non-executive and unconnected. I believe the listing requirements still have too great a bias to directors with connected or related experience, rather than emphasising stature and independence.

For, while the jury is still out on whether Boards should be largely executive or non-executive - and whether non-executives should be familiar with the business, or bring in a fresh perspective and a broader industrial experience - I do think that audit committees should be dominated by truly unconnected, independent non-executive directors.

And there is one further role for this audit committee. That is in policing not only connected contracts and beneficial material interests, but in reviewing all beneficial interests, whether emerging

as part of contracts or not. Many public companies have made minority investments in others. Often these other companies are private and the interest is minor enough not to make the investee company a subsidiary undertaking. What then often happens is that a director or manager of the public company may co-invest alongside the public company's investment, or may represent the public company's investment in a board capacity on the private company. From that fees or other rewards are often gained.

In principle, neither of these is wrong. But if a director is representing an investment, all fees should be paid back to that parent company and the reward from the parent company - his true employer - should reflect the duties involved. That makes it quite clear what interests are being represented. Conflicts can only be avoided if the individual has no investment alongside that which might colour decisions - particularly if trading problems are encountered and further investment is sought.

Now, of course, the buy-out and venture capital market works on incentivisation of venture capital managers by co-investment - but this need not breach my principles. For, in representing the venture fund, fees can still be returned to that fund. And, where co-investment is made by managers, that should be done on a basis that does not cherry pick - either the same absolute amount or proportionate investment should be made in every single investee company.

Many investments by public companies from which directors of those public companies are drawing benefits are never disclosed. They are not only not voted on by shareholders, but typically never even reported in the annual accounts. They generally only emerge when examining the shareholder records of private companies.

I do think that much wider disclosure is now needed to reflect the evolving views of institutional investors and the degree to which there has tended to be a pattern within problem companies of conflicts. It is not the materiality that is important, but the principle. Corporate governance in the 1990s to institutional investor standards requires disclosure of all rewards gained in the course of employment or stemming from the public company - whether through its direct pay or from companies in which it has made an investment. If that is fully disclosed, investors can then make up their own minds.

In summary, as an institutional investor, I welcome the way in which the Stock Exchange has actively adapted itself to meet the needs of investors. As a user, having been involved in listings of investment trusts - and few institutional investors who have not done this truly understand what indemnities, warranties and commercial risks in listing involve - I have also had good experiences of the Stock Exchange. I have no doubt that through the 1990s it will continue to move in the direction in which users want.

The Stock Exchange and its customers in the 1990s

Conference Programme

28th May 1992

3.30 pm	**Registration/Coffee**	
4.00 pm	**Introduction**	Robert White, Regional Chairman, Scotland
4.10 pm	**Keynote address**	The Rt Hon George Younger, Chairman, The Royal Bank of Scotland plc
4.30 pm	**The interests of the private investor in the UK**	Geoffrey Maddrell, Chief Executive, ProShare
4.45 pm	**The fund manager's perspective**	Colin McLean, Managing Director, Scottish Value Management Ltd
5.05 pm	**Tea interval**	
5.20 pm	**The perspective of the independent private client broker**	John Torrie, Senior Partner, Torrie & Co
5.40 pm	**The health of London's market**	Peter Rawlins, Chief Executive, London Stock Exchange
6.00 pm	**Panel discussion**	Chaired by Robert White
7.00 pm	**Cocktails**	Sponsored by local market makers: Aitken Campbell & Co Ltd and R A McLean & Co Ltd
7.30 pm	**Dinner**	After dinner speech by Mr Robert Smith, Chairman and Chief Executive, Morgan Grenfell Development Capital Ltd
10.30 pm	**Close**	

London **STOCK EXCHANGE**

Barbour Index plc
annual report and accounts 1992

An example of good practice

specialist information services

3 Other operating income

	1991 £000	1992 £000
Rent and service charges receivable	204	120

4 Operating profit

	1991 £000	1992 £000
This is stated after charging:		
Directors' emoluments	342	367
Depreciation of tangible fixed assets	354	378
Auditor's remuneration: Audit work	30	30
Auditor's remuneration: Non-audit work	8	7
Hire of motor vehicles	—	44

5 Directors

	1991 £000	1992 £000
Directors emoluments:		
Remuneration and benefits	327	300
Pension contributions	15	16
	342	316
Remuneration of the Chairman	23	20
Remuneration of the highest paid Director	118	140

Other Directors' remuneration fell into the following bands:	Number	Number
£0 – £5,000	3	3
£5,001 – £10,000	—	1
£55,001 – £60,000	1	—
£115,001 – £120,000	1	—
£120,001 – £125,000	—	1

£59,420 (1991: £51,559) was paid to the company in which Mr D N Lee has a substantial interest in respect of his services and expenses as a Director.

The amounts of emoluments shown above exclude £52,500 (1991: £52,500) paid by the Company to P F Barbour in respect of his services as Deputy Chairman of Microgen Holdings plc which are recoverable from that company by Barbour Index plc.

6 Staff

	1991 £000	1992 £000
Wages and salaries	2,071	2,344
Social security costs	205	220
Other pension costs	73	96
	2,349	2,660
The average weekly number of employees during the year was	155	151

7 Interest receivable

	1991 £000	1992 £000
Interest from banks	517	429

8 Tax on profit on ordinary activities

	1991 £000	1992 £000
The tax charge for the year is:		
Corporation tax at 33 percent (1991: 34 percent)	1,163	1,263
Prior year adjustment	2	(4)
	1,165	1,259

Report of the Directors for the year ended 30 April 1992

Results and dividend

The results for the year are set out in the attached financial statements.

The Directors recommend the payment of a final dividend of 4.85p per share of 25p (payable on 5 October 1992 to shareholders registered on 3 July 1992) which, together with the interim dividend of 2.4p per share, will make a total distribution for 1992 of 7.25p per share, being £1,207,000 with £1,236,000 transferred to reserves.

Principal activities

These are described in the Company profile.

Developments in the business

This is covered in the Chairman and Chief Executive's review.

Employees

The Company's policy is to provide employees with regular information on matters of concern to them and to consult them regularly, as far as is practicable, so that their views can be taken into account when decisions are taken which could affect them. A copy of the Annual Report and Accounts is sent to all employees.

It continues to be Company policy to give full and fair consideration to disabled persons applying for employment, having full regard to their particular aptitudes and abilities. Full and fair consideration will be given to the continuing employment and appropriate training of persons who become disabled. The Company's policy is to provide equal opportunities to all its staff on the basis of objective criteria and personal merit.

Political and charitable donations

During the year the Company made a political donation to the Conservative Party of £3,500. Charitable donations of £1,860 were made by the Company.

The notice of meeting includes a resolution, proposed as special business, to authorise the Directors to make a contribution to the Conservative Party of £3,500 for the current year.

Share capital

This is described in Note 16.

Fixed assets

Changes in fixed assets are set out in Note 11.

Significant contracts

There are no significant contracts between the Company or any of its subsidiaries and any corporate substantial shareholder.

There are no contracts for the provision of services to the Company or any of its subsidiaries by a corporate substantial shareholder.

Taxation status

The Directors have been advised that the Company is not a close company as defined by the Income and Corporation Taxes Act 1988.