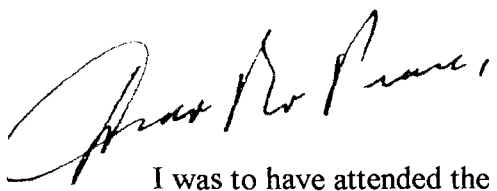


CAU- 02701
cc in Annex

Potters' End, Mears Ashby
Northampton NN6 ODZ
0604-810509 [fax on request]

Nigel Peace Esquire
Secretary,
Committee on the Financial Aspects of Corporate Governance
PO Box 433, Moorgate Place
London EC2P 2BJ

17 September, 1992



Corporate Capitalism.
Managerial Capitalism
Alfred Chandler 1977

I was to have attended the meeting arranged with Donald Butcher and other members of the nascent UK shareholders' Association, which I gather has been arranged for October 1st next. Unfortunately I shall be on holiday until that date.

During the past few weeks, and particularly since the Panorama programme on pay, one has become aware of a growing tide of opinion which calls in question the accountability of Boards, to the extent that the Cadbury proposals are being questioned on the grounds that only the best companies will follow them. I do not myself take a black and white view of this, but that these views are held is cause for concern.

I am writing before I know what role PROSHARE is writing for itself [I believe the launch is today], but I gather it is seen as purely promotional. Unless some means is found of persuading private shareholders that they can have an effective voice, this initiative will not reverse the inevitable decline of privately held shares. The many people who have been in touch with me since the Panorama programme encourage this view.

The enclosed paper is my own view of how shareholders at large can be empowered, and offers one method of bringing institutional and concerned private shareholders together. I have sent to other members of our group for comment, but would be glad of your own views when you have the time. The fear that most of us have is that sooner or later we shall have regulation imposed with a heavy hand.

Yours sincerely,



Derek H Broome

enc:

CORPORATE GOVERNANCE AND THE PRIVATE SHAREHOLDER

A SUBMISSION TO THE CADBURY COMMITTEE

Derek H Broome MA CBIM

Derek Broome is a substantial private shareholder administering three trusts as well as the estates of his wife and himself. Participation in equities has been substantially reduced in recent years and less than 10% by value is currently invested in some 20 different holdings. With others he is currently seeking to set up a representative organisation for private shareholders in the UK and acknowledges inputs from Dr Maurice Gillibrand [to whom he is indebted for the idea of shareholders' representative bodies] and to Donald Butcher who have made separate submissions to the Committee.

The Shareholder as the Monitor of Governance

The writer strongly supports most of the recommendations of the Cadbury Committee, but has become convinced that these will be followed only by those Companies which already have an enlightened policy towards their shareholders. Without some sanctions the abuses of a minority will continue, and legislation and regulation will inevitably follow further scandals. It is in the interests of both shareholders at large and the many well-regulated companies that teeth be provided at this stage rather than chains in the form of broad legislation and detailed regulation later.

Unless positive steps are taken to encourage and empower shareholders at large to take a more active part in the affairs of their companies, there is probably no alternative in the long run to the establishment of a Securities and Exchange Commission in the UK or possibly the introduction of two-tier boards.

Although large institutional shareholders must take a leading role in improving governance, the private shareholder could and should have a distinct part to play.

Wider Share Ownership

Public policy has been directed towards promoting wider share ownership for many years, on the following principal assumptions:-

- **It will give more people, including employees, a stake in the success of business and help promote an 'enterprise culture'.**
- **It is an alternative to state ownership.**
- **Personal share ownership is seen as a useful corrective for alleged 'short-termism' among institutional holders.**

The Conservative Government has introduced many schemes to promote personal shareholding, but although privatisation and employee schemes have vastly increased the number of holders to some 11 million, the relative value of equities held privately has declined steadily. Institutions held some 50% by value in 1964, and it is estimated that the proportion now held directly by individuals is only 20%. Some Government initiatives, such as PEP's have actually increased the number of nominee shareholdings by advisers and institutions.

The theory of the joint stock company [probably the most significant invention of the Western world] was that the management was controlled by the people who undertook major, if limited, risks in return for higher returns than Government stock. This worked well when shareholders were fewer and usually known to each other, and when inflation bond yields low. The assumption that managements are responsible to stockholders has persisted into a post-war inflationary era where this has ceased to be so.

In recent years equities were seen as a hedge against inflation when fixed interest stocks offered small or even negative real returns, and people making such investments had little incentive to partake in the actual governance of the companies involved. Efficient trading in shares meant that informed

shareholders, particularly larger institutions could vote with their feet rather than involve themselves in tricky intervention.

There is now a paradigm shift in the economic and social climate following the collapse of the Communist bloc, the decay of the US economic system, and the peaking of the Japanese 'miracle' which profoundly affects the supply of credit. The cult of equities as a better store of wealth and generator of inflation-proofed income is in question, particularly when index-linked and similar securities offer good real returns with safety.

Fiscal biases towards institutional and nominee shareholdings contribute to the decline in private shareholding, and certainly the more sophisticated shareholder will continue to avoid investments where effective control is with others. The writer is aware of widespread cynicism about corporate governance and the role of institutions in monitoring it. Whether this cynicism is justified or not, the perception is bad for the future of wider shareholding and for the best practice already current in many larger companies.

The Larger Private Shareholder

There are said to be some 11 million shareholders, but the majority of these have small holdings of one or two privatisation issues or in employee schemes. They may quite properly regard their investments as a 'punt' or an interest in the company in which they work. Enlightened boards value such holdings both for the stability they give to their equity, and for the benefit in corporate, employee, or even customer relationships which they can generate. The more substantial investor however, has to adopt the following principles in order to minimise transaction costs and spread risk.

- A minimum holding of £3,000
- A spread of at least 10 holdings

In order to justify an equity holding of [say] £30-40,000, one should already have net liquid assets [excluding pensions, insurances &c.] of approximately £30,000 which can be deployed in TESSAS and National Savings, currently yielding 4.5-5% net of tax in real terms. Equity in house property could be £70-100k net of the MIRAS limit of £30k.

A serious investor in equities should normally therefore have a net worth of not less than £150,000 excluding pension and insurance rights. Of the £30k available for investment at risk, some might be pre-empted by Government stocks. A married couple would be able to double the takeup of TESSAS and NSC's, increasing the net worth before investment. Where one spouse is not earning taxable income, a further non-equity investment in Gilts under the National Savings register offers tax-free dividends.

People wishing to treat equities as an investment, if properly advised, will not therefore normally be found among people of less net worth than [say] £150k or £200k for a married couple. It is dishonest to promote equities to people who still have debt unrelieved by tax breaks and have not taken up their quota of high coupon tax-free National Savings.

The Importance of Private Shareholders

Lip service is paid by Government and others to the importance of wider share ownership in fostering a climate of enterprise and in associating the prosperity of businesses with employees. Very little thought however has been devoted to its importance to good governance and in preventing abuse.

There are many highly sophisticated investors, many of them former senior executives, whose judgement is at least as good as the administrators of institutional funds who were happy to entrust other people's money to Polly Peck, Maxwell, et alia. Despite the efforts of institutional associations to lay down sound guide-lines for corporate governance, people who have their own money on the line are more directly motivated to see that their investments are being properly safeguarded and enhanced.

For these reasons, it is essential that the collective and individual voice of private investors be heard in corporate affairs.

In practice even the larger private holder is powerless. Institutions hold a large proportion of the shares, and most companies offer briefings to institutions which give them insider status denied to shareholders at large. Worse still, the articles of almost all companies, including those recently privatised, put barriers in the way of shareholders wishing to be represented or to aggregate their voice.

A major obstacle to effective shareholder power is the inability of proxies to speak at meetings. This is especially vexatious now that separate taxation of spouses makes it advantageous to split shareholdings between them. There would seem to be no valid reason for this prohibition, since special interest groups already use one share to make propaganda points at AGM's, and nominee or institutional holders can send people to speak on their behalf.

It is therefore argued that public policy should be directed toward encouraging and empowering involved private shareholding, and that this should be targeted towards the larger shareholder, while encouraging smaller shareholders to aggregate their interests.

Shortcomings of General Meetings

The AGM or other general meetings are too often ineffective as a means of expressing private shareholders' views for a variety of reasons:-

- Most Company Articles prohibit the representation of individuals or groups of shareholders by their proxies other than on a poll [the writer was even denied the right to speak when holding power of attorney]. This discriminates against private shareholders, particularly as AGM's may overlap, may come during holidays, or be geographically difficult to attend. Nominees of institutions, by contrast, have the right to speak, and pressure groups can speak with one share.
- Many companies now sublet the management of their AGM's to PR firms specialising in the field, and questioning is tightly controlled; computerised registration and monitoring allows the Board to prehandle awkward questions, and check the register to weed out proxies and to highlight people holding nominal shareholdings, who are often asked to state the amount held.

- Where there are large customer and shareholder bases in common [for instance in recently privatised utilities] general meetings can be dominated by customer queries. The chairman should strictly speaking rule these out of order, but a few actually encourage such domination to head off serious queries.
- The information contained in the annual report can be limited to the statutory requirements to an extent which precludes informed questions. By example, the writer asked East Midlands Electricity plc what were the returns on investment in retailing and other non-core businesses. This information was refused, and the writer referred to the reports under regulation. He was also refused information about the proportion of office and other building included in investment in fixed assets.

It should be said at this point that some Companies in fact run excellent AGM's and encourage shareholder participation fully within the limits of the medium.

Empowering Shareholders

Unless responsible private shareholders can feel that they are taken into the confidence of managements and that their sensible views are respected, it is unlikely that the long term shift to institutional shareholding will be reversed. The writer has considered several options for reforming governance, including two tier boards, or the non-executive constituency which is favoured by some as an alternative.

All directors should be jointly and severally responsible for the governance of the company; any two tier system, including the setting up of remuneration and other committees of 'non-executive' directors breaches the principle of collective responsibility. The present system lacks accountability of directors to the owners, and too many boards become self-perpetuating oligarchies where appointments, and the terms and conditions of such appointments, are accepted on the nod.

To redress the balance between the ownership and the directors, some representative body of shareholders should be set up for all quoted companies. The writer has considered, but rejected ideas such as two tiered boards, or non-executive directors elected by shareholders on an annual or other basis on the grounds of divided responsibilities. Shareholders at large must be given a constitutional voice in the affairs of public companies short of detailed interference in the management.

It is therefore recommended that all public companies should be obliged by statute or listing requirements to set up shareholders committees on the lines suggested below:-

- There should be not more than ten members of the Committee, who should be elected at the AGM by two constituencies, representing institutional and individual holders. The members will hold no office with the Company.
- The Committee should be an advisory not an executive body except as set out below in relation to the appointment and contracts of directors. It should render its own annual report on all matters, and where necessary its own recommendations alongside the Company report. It should have its own modest secretariat.
- The Committee should have the powers to requisition any information from the directors agreed at general meetings as well as that required by statute. The directors should also call meetings of the Board and the Shareholders' Committee not less than once a quarter and render a report to the latter on the progress of the Company.

- No new appointment to the Board or variation to the contract of any director should be made without the prior approval of the Shareholders' Committee, who may in the case of disagreement refer the decision to a general meeting.

Large institutional shareholders should clearly have a significant voice, but reserved places on any such body should be kept for individual shareholders. Further and deeper thought needs to be given to the constitution of such a shareholder's committee, but unless some such reform of governance is undertaken, the alternative will almost certainly be a further decline in the proportion of private shareholding, and a growing demand for regulation on the lines of the USA Securities and Exchange Commission, or even some move to corporatist structures on the German model.

Conclusions

- The recommendations of the Cadbury Committee will be followed mainly by those Companies already adopting good practice.
- There are no effective sanctions against companies wishing to flout Cadbury recommendations
- Recent scandals have cast doubt on the whole principle of self regulation and will fuel growing demands for statutory regulation and/or reform.
- The empowerment of shareholders is a viable alternative to statutory regulation and the establishment of obligatory shareholders' committees should be given considerable further thought.
- The law should be amended to allow all shareholders to be represented by proxies with full powers.
- Institutional shareholders are seen as a major force for improving corporate governance, but the special interests of private shareholders should be recognised by preserving an elected constituency for them on any shareholders' committee.

Derek H Broome Issue 1.1

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