CAD- 02269

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COMMITTEE
ON
THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

c/o The London Stock Exchange
London EC2N 1HP
Tel: 071-797 4575
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9 July 1993

Dear Committee Member

Please do not be deterred by the bulk of the enclosures to this letter, they do not all require detailed comment!

Coopers & Lybrand - Implementing the recommendations of the Cadbury Committee

An encouraging report. It would be interesting to compare with the results of a similar survey of a sample of smaller companies. I understand from David Pimm at C&L that they have no immediate plans to do so, but may consider it in the future. If you have any comments on the report which you would like relayed to Coopers & Lybrand, I will co-ordinate a response.

Auditing Practices Board - draft bulletins on " Disclosures relating to Corporate Governance" and "Review of Interim Financial Information".

As you will see from the copy of the covering letter to Sir Adrian Cadbury, the APB is requesting written comments on the above proposed guidance. I will co-ordinate a response to go out under Sir Adrian's signature and if you have comments you wish to include, I should be grateful to receive them no later than Friday 24 July, in order to meet the APB's deadline of 30 July.

Guidance for Directors drawn up by the Working Party on Internal Control

This document is circulated mainly for information, although if you do have comments I will be happy to co-ordinate them. As pointed out in Paul Rutteman's letter, the document is the result of 17 re-drafts. Its publication is being delayed pro tem in view of the "overload" situation.

I am also enclosing herewith a copy of a press statement made by Sir Adrian Cadbury and Sir Ron Dearing supporting the ASB's proposals on Operating and Financial Review, and also drawing attention to the need to address the other initiatives on corporate governance in a co-ordinated way.

Best wishes

Gina

Gina Cole
Secretary

CAD-02269

Listed subsid. co's wld be included in parent's compliance statement. See how it works out.

Shld. extend Parent's compliance embraces subsidiary

CFACG(93)3rd Meeting

COMMITTEE ON THE FINANCIAL ASPECTS

OF CORPORATE GOVERNANCE

The next meeting of the Committee will be held in the First Floor Committee Room at the Bank of England, Threadneedle Street, London EC2 on Thursday 9 September, beginning at 4.00 pm.

Agenda

1. Apologies for absence. Nigel Macdonald, Dermot de T., Jonathan
2. Minutes of previous meeting held on 3 June, already circulated.
3. Extension of the Report's recommendations to large private companies - paper by Jonathan Charkham attached - CFACG(93)7. deferred.
4. Recognition of "smaller companies" as a separate group- paper by the Secretary attached - CFACG(93)8.
5. Monitoring Sub-Committee - verbal up-date of progress by the Sub-Committee Chairman.
6. Rolling Contracts - correspondence with EMAP plc - paper by the Secretary attached - CFACG(93)9.
7. Use and meaning of terms "executive" and "non-executive", letter from IIMR attached - CFACG(93)10.
8. Any other business.
9. Date of next meeting - 3.00 pm on Wednesday 24 November 1993.

a). Particip'n in ABI.
b) ICAEW academic research in field
c). Adhoc. (trawl) Spontaneous interest. ABI may initiate own research

ABI systematic collection of data. £15,000.

Gina Cole
Secretary
2 September 1993

CFACG(93)7

COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

Extension of the Report's recommendations to large private companies

Article by Jonathan Charkham which first appeared in the August edition of "Governance" magazine.

"The Cadbury Committee was concerned mainly with quoted companies - quite properly so since the Stock Exchange was one of its sponsors and so much of the UK's business is conducted by them (a much higher proportion than in Germany and Japan). The Report (para 3.1) did however state "We would encourage as many other companies as possible to aim at meeting its (the code's) requirements". There are indeed some important issues to be considered about the governance of unquoted companies.

Although such companies are technically private property, they have public effects both in prosperity and failure. The nature of the market system is to accept the risk of failure as part of the price of progress: growth may often reduce that risk but it always increases its consequences. The closure of the corner shop can marginally inconvenience its neighbours; the bankruptcy of a major employer can devastate a town.

Any business may fail. But the bigger a business becomes the greater the obligation of the directors to all who depend upon it, employees, customers, suppliers and neighbours, as well as shareholders, not to fail needlessly. The larger it grows the more is staked on the competence of its directors and the greater the need for a governance system which helps it maintain its standards. We can express this in terms of accountability by saying that the bigger a business gets the greater the accountability of management should be: the degree of accountability should not just depend upon whether a company is quoted or not, but also on its size and its consequent potential effect upon society.

At the present time UK does not accept this proposition. True, there are obligations on directors of quoted companies which do not extend to private companies, but no company need have more than two directors (Companies Act 1985, Table A, Sec. 64), nor a board. The law only recognises one class of director. The Cadbury Committee (1993) inter alia requires all quoted companies to have some directors to have no executive duties and indeed to be independent and it proposes that it is they who should constitute audit and remuneration committees. It further requires that boards that meet regularly and have certain decisions reserved to them. But the Cadbury Committee's remit does not extend to unquoted companies whatever their size.

The Germans have long taken a different view. An unquoted company (GMBH) must nevertheless have a supervisory board with employees constituting a third of it. The purpose of such arrangements is not just to give the workforce its say, but to ensure a proper process. This cannot in itself ensure success, but its benefits should not be overlooked. It means regular (though not necessarily frequent) board meetings and having to prepare proper proposals. It means more light in dark corners. It creates, however imperfectly, a system of accountability.

If we accept the idea in principle that the process of governance should reflect in some way the increases capacity of a company to inflict damage through inefficiency or avoidable demise, the instrument in the UK model which needs adapting is our unitary board. The UK tradition would seem to rule out a two tier system; and there is little current support for employee representation.

The logical approach would therefore be to extend the Cadbury Code to big companies - say those with more than 500 employees in the group. This would mean their having non-executive directors and audit committees. It would also oblige them to have meaningful reports and accounts in which among other things the background of the non-executive directors would be described, and their role in the company's governance.

As the power of appointment of directors would still rest with the shareholders, whose representatives would in many cases dominate the board, the whole exercise might appear to be pointless. Stooges, it is argued, would be chosen, to be used at random and dismissed at will. But it is not as simple as that. The background of the directors would be stated and could be ascertained by anyone interested in the company. Their dismissal or resignation could become matters of public interest. Perhaps their independence could be buttressed by securing them against capricious dismissal, which might require a super majority of say 75% of the shares. [A fortiori there is a case for such a requirement for quoted companies to cover cases a' la Maxwell where there is a majority shareholder (or shareholding group) on the board.] Such a system would be far from perfect but it would be better than what we have now. It would moreover strengthen private company boards in a more constructive way by bringing on to them outsiders who, if sensibly chosen, could supplement existing skills.

I do not contend that there is a case for extending the Cadbury Code to small private companies, even though they too would often find non-executive directors useful. Small businesses are typically rich in some skills and poor in others; suitable NEDs can often provide the necessary balance or make sure it is obtained. They are an inexpensive way of getting not just advice from people committed to the company and it is commitment that lies at the very heart of the private company. But commitment and motivation, though necessary, are not sufficient. Motivation without competence is probably even less productive than competence without motivation.

The modest proposals in this article address the issue of continuing competence in significant companies. We all know that in the short term it is possible to get away with any kind of governance system. If we want sustained progress a good governance system will help achieve it, though nothing ensures success for ever."

CFACG(93)8

COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

Recognition of "smaller companies" as a separate group.

Note by the Secretary

1. A recent article in Accountancy Age reported that both the ACCA and the City Group for Smaller Companies had called for amendments to the Code to make it more applicable to smaller listed companies. It goes on to report that CISCO and ACCA claim that the Code is not suited to smaller listed and private companies and imposes a cost and administrative burden on them. Both groups claim that smaller business will take no action to implement even the spirit of the Code if it is not amended. CISCO's Graham Cole is reported as saying that ".Discussions with smaller company directors revealed reactions to the full implementation of the Cadbury code varying from the mildly apprehensive to the horrified". At the time of writing, the head of CISCO, Richard Balarkas, is on holiday and the Secretary has been unable to contact him for further details.

2. The ACCA is apparently considering working with Robson Rhodes to formulate ways in which small companies can abide by the spirit of the Code "so as to avoid not implementing any of it" (sic). The Senior Technical Officer in charge of the research at the ACCA has advised the Secretary that the work is at an early stage and it is unlikely that anything will be published until the Autumn.

3. The Committee did discuss the question of smaller companies prior to the publication of the Report and decided against any special provision for them.

<u>What constitutes a "smaller company"?</u>

4. One of the problems which arises when considering smaller companies is finding a satisfactory, and universally accepted definition. The Companies Act in Section 246-7 does have a definition of small and medium-sized companies*, but this applies only to private companies, not listed ones. CISCO defines smaller companies as ".. those which are not included in the FTSE 100, FTSE 250 and FTSE 350 indices. The definition therefore includes companies with a market value roughly below £150m...". Another view put forward within the Stock Exchange is a company with a turnover of less than £250m.

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*	Small Company	Medium Sized Company
Turnover	Not more than £2m	Not more than £8m
Balance sheet total	Not more than £975,000	Not more than £3.9m
Number of employees	Not more than 50	Not more than 250.

5. Should the Committee decide to look seriously at the amendment of the Code to suit smaller companies, an acceptable definition will have to be agreed. Complications would inevitably arise when a company increased or decreased in size during the course of a financial year and moved in an out of the " smaller company" category, and would presumably have to make two sets of compliance statements covering its altering status.

5. Furthermore, companies may use the excuse of smaller company status to avoid compliance with the Code in any respect.

6. Finally, if the Committee makes provision for the smaller company, would this lead to pressure for relaxation of the Code from other interest groups, and ultimately the total dilution of the Code?

7. Research carried out by Coopers and Lybrand into the FT top 200 companies (previously circulated to Committee Members) showed that nearly all respondents had a generally favourable attitude to the Report, and the majority (83%) intended to comply with the Code in full by June 1993. The Secretary has been advised that Coopers and Lybrand probably intend to carry out a similar survey of smaller and medium sized listed companies. When the results are published, it will be interesting to compare them with those from the larger companies, and also to see if they add veracity to the statements reported in paragraph 1 above.

8. The Committee are asked to note and comment on the views expressed by CISCO and the ACCA, and to advise whether they consider any further action is necessary at present. In the interim, the Secretary would propose gaining further information from both CISCO and ACCA when available.

Gina Cole
Secretary
2 September 1993

CFACG(93)9

COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

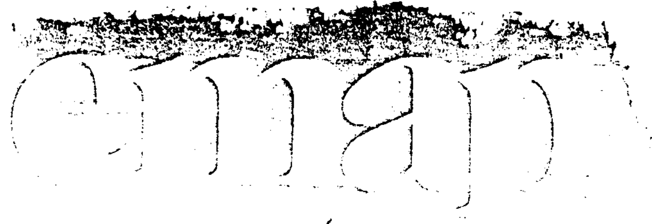
Rolling Contracts - correspondence with EMAP plc

Note by the Secretary

1. You will find attached copies of an exchange of correspondence between the Chairman and Graham Ross Russell, Chairman of EMAP plc.

2. The Committee are asked to consider whether it is in agreement with the response given to Mr Ross Russell on the question of rolling contracts, and to consider whether the whole area of rolling and fixed-term contacts is one which should be put to the Committee's successor body in June 1995.

Gina Cole
Secretary
2 September 1993



Scriptor Court, 155 Farringdon Road. London EC1R 3AD. Telephone: 071 278 1452. Fax: 071 278 6941.

14 July 1993

RECEIVED

15 JUL 1993

Sir Adrian Cadbury
25 Berkeley Square
LONDON W1X 6HT

I had the pleasure of meeting you when I chaired a dinner meeting at the Athanaeum a few months ago on the subject of your report.

I would be most grateful if you could help me in one particular area where I understand your committee did not make their views clear, and that is in relation to rolling or evergreen service contracts for directors.

I believe that your committee recommended that "normal" directors' service contracts should not exceed three years without shareholders' approval, but I am not clear whether you expressed a view as to the position of rolling contracts. My memory is that, at a PRONED conference which you were at and which I also attended, it was said that your committee's views were that rolling contracts should not exceed one year, but I've also been told that your committee's "telephone helpline", when asked this question said that your committee was content with rolling contracts of up to three years duration, provided that the directors concerned came up for election at regular intervals.

Even if your committee did not express a view, I would be interested to hear your opinion of current "best practice" in the area of rolling contracts.

Yours sincerely

Graham Ross Russell
Chairman

20 July 1993

Mr Graham Ross Russell
Chairman
Emap
[illegible]
155 Farringdon Road
London EC1R 3AD

I well remember our meeting at the Athenaeum and thank you for following up that discussion with your letter.

The first point to make in answer to your query is that the Committee aimed throughout to avoid being prescriptive. Our aim was to set down principles and guidelines within which it was for boards and their shareholders to determine how they should be implemented in any particular case.

The only recommendation which we made on contracts was that the Companies Act should be brought into line with accepted practice. Beyond that, we would expect boards to disclose their policy on contracts so that they can ensure that they have shareholder support for them. It would be quite inappropriate for us to give a view on any particular contract since it is for boards to decide what package - of which the contract is only a part - you need to offer a given director in order to get the person you want.

I know that Postel have written to companies about rolling contracts and it seems to me right that shareholders should take up the issue with boards where they have doubts about what is being done. I note however that Postel's letter accepts that there may well be particular circumstances where three year rolling contracts are acceptable to them. This is further evidence that any dogmatic assertion about the form which contracts should take would be a mistake.

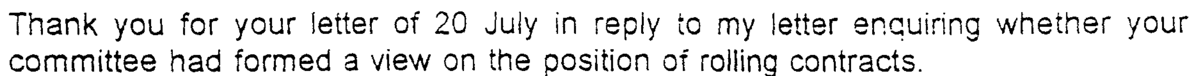
My main concern is that boards should sort these matters out for themselves and not look to the Committee for guidance which it is in no position to give in any individual case.

Thank you for writing.

Scriptor Court, 155 Farringdon Road, London EC1R 3AD. Telephone: 071 278 1452. Fax: 071 278 6941.

23 July 1993

Sir Adrian Cadbury
Financial Aspects of Corporate Governance Committee
c/o The London Stock Exchange
LONDON EC2N 1HP



Thank you for your letter of 20 July in reply to my letter enquiring whether your committee had formed a view on the position of rolling contracts.

Thank you for your comments. I totally agree that it is for a Board of Directors to sort out these matters in the light of particular circumstances.

Graham Ross Russell
Chairman

CFACG(93)10

COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

Use of the terms "executive" and "non-executive"

Note by the Secretary

1. The attached letter from the Institute of Investment Management and Research (IIMR) sets out a perceived confusion over what constitutes an executive and non-executive director, particularly in relation to the role of the Chairman.

2. Terminology has not prompted a large number of either telephone or written queries to the Secretary, and it is probable that the majority of companies have made their own interpretation of the Report and Code in relation to the role of the Chairman, and are prepared to justify it to shareholders.

3. However, the points made by IIMR are valid and the Committee may wish to consider whether they should ask the Secretary to investigate this area further to establish whether a true problem of interpretation exists, and/or whether it is one which the successor body may wish to consider.

Gina Cole
Secretary
2 September 1993

INSTITUTE OF INVESTMENT MANAGEMENT AND RESEARCH

23 August 1993

Formerly
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Gina Cole
The Stock Exchange
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Dear Ms Cole

The Cadbury Report

You may recall that we spoke some three weeks ago on the text of the above report. I also spoke, at your suggestion, to Margaret Brewster at Pro Ned. You mentioned that you were recording comments which may lead, in due course, to amendments to the Report. I promised to write and set out the conclusion of those conversations and that is the purpose of this letter. (The delay in writing is due to an intervening holiday which I mentioned when we spoke).

The Institute has supported the recommendations of the Cadbury Committee and contributed through comments at the discussion stage. The Council of the Institute (of which I am a member) has established a committee to prepare comments on discussion documents issued by the accounting bodies and other standard setting organisations. As a member of that committee, it is my responsibility to prepare draft comments for consideration by the commitee and, after discussion, to finalise the Institute's submission. I should emphasise that I am not writing with any new comments of the committee but simply to clarify some aspects of the Report which could be misinterpreted.

The main points we discussed were the use and meaning of the terms **executive** and **non-executive** particularly in relation to the chairman of a board. Where the label **executive/non-executive** is applied to a director who is not the chairman then the position is clear and the introduction of the further qualification of **independent** is also clear. Thus there are two types of non-executive director - those who are independent and those who are not.

In the case of the chairman, it is not so clear. The Report rightly emphasises the special role the chairman plays. However, the Report does not describe chairmen as either executive or non-executive. No such distinction is made.

The penultimate sentence of paragraph 4.11 contains the requirement for boards to include a minimum of three non-executive directors **"one of whom may be the chairman provided he or she is not also its executive head".** Although my personal view is that the text is reasonably clear, there is the possibility of confusion.

I think that there are two areas of possible confusion where the text could be modified to minimise any doubt.

First, the requirement that the chairman should not be the "executive head" (if he/she is to count towards the requirement for three non-executives): if, as I understand it, the term "executive head" is not intended to mean anything different to the terms "chief executive" or "managing director" then it would be preferable to avoid it and use either of the latter terms.

This would help minimise any confusion arising from the different perceptions of the role of chairman. As we discussed, some chairmen describe themselves as executive while others prefer non-executive. A third category use neither term. This is the essence of the second point.

There is a danger that the wording in paragaph 4.11 (see bold extract above) might be misinterpreted as meaning that the chairman qualifies as one of the three non-executive directors required by the Report **only if he/she is a non-executive chairman**. This would therefore exclude those chairmen describing themselves as "executive" and possibly also those describing themselves as neither "executive" nor "non-executive" . Some of the chairmen excluded in this way might also satisfy the criteria of "independence" and should certainly count towards the required number of non-executive directors.

At your suggestion, I spoke to Margaret Brewster at Pro Ned and sought their views on the correct description of chairmen. Ms Brewster told me that Pro Ned does not recognise the terms **"executive"** or **"non-executive"** as applying to chairmen. Instead, Pro Ned distinguish between full-time and part-time chairmen. This reflects the special role of the chairman. I think that this could usefully be included in any revision of the Report.

Ms Brewster's view on whether a chairman would count towards the minimum number of non-executive directors was that eligibility depended only on whether the chairman in question was independent. Thus, if the chairman satisfied the criteria as being independent, then he/she would count towards the minimum requirement. This coincided with your own interpretation.

Paragraph 4.11 could perhaps be amended to reflect this by specifying the required structure of each board in the following terms:

Where the chairman is not "independent"

> there should be a minimum of three other directors each of which is non-executive and of whom at least two are "independent".

Where the chairman is "independent"

> there should be a minimum of two other directors each of which is non-executive and of whom at least one is "independent".

However, although the above wording clarifies the position in relation to paragraph 4.11, the same point arises elsewhere. The phrase **"non-executive directors"** is used in other parts of the Report. For example,

i) paragraph 4.15 makes recommendations as to the appointment of **non-executive directors**;

ii) paragraph 4.35 recommends that membership of the audit committee be confined to **non-executive directors**;

iii) paragraph 4.42 recommends that the remuneration committee be chaired by a **non-executive director**.

In each case, it cannot be intended that the references to **non-executive directors** should exclude independent chairmen. Some additional clarification to the text would therefore be helpful.

There are a number of alternatives: i) a reference to independent chairman could be included wherever there is a reference to non-executive directors: ii) a new term could be introduced such as "qualifying director" which could be defined as including both non-executive directors and, where relevant, an independent chairman (although the use of a further label is to be avoided if possible); or iii) the text could include, at an early stage (eg in paragraph 4.11) a statement that references to **"non-executive directors"** is intended to include the chairman where the chairman is also **"independent"**. This last suggestion would obviate the need for the wording proposed for paragraph 4.11 above.

I am sorry this letter is rather long. However, chairmen are continuing to describe themselves in a variety of ways and the Cadbury Report could help rationalise practice in this area by reinforcing the lead of Pro Ned.

Please let me know if you disagree with any of the above (my office number is 071 621 1770). I am copying this letter to Margaret Brewster at Pro Ned.

Yours sincerely

Paul H Richards

cc Margaret Brewster, Pro Ned
cc George Dennis, Chairman, IIMR Accounting and Investment Analysis Committee
cc Paul Hewitt, Assistant Secretary, IIMR.