COMMITTEE ON CORPORATE GOVERNANCE

Final Report

January 1998

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FOREWORD

1 This Committee on Corporate Governance was established in November 1995 on the initiative of the Chairman of the Financial Reporting Council, Sir Sydney Lipworth. This followcd the recommrndations of the Cadhury and Greenbury committees that a new committee should review thr implemrntation of their findings. The present committrr's remit and membership appear in the Annex.

2 The committee's sponsors are the London Stock Exchange, the Confederation of British Industry, the Institute of Directors, the Consultative Committee of Accountancy Bodies, the National Association of Pension Funds and the Association of British Insurers. We should like to acknowledge their help, without which it would not have been possible to publish this report.

3 The Committee has consulted widely. Before the preliminary report the Committee issued a questionnaire in answer to which over 140 submissions were received, and members of the Committee took part in over 200 individual and group discussions. We received a further 167 written suhmissions on the preliminary report and we have had a substantial number of further discussions. In total 252 organisations or individuals responded in writing to one or both of these consultations. The breakdown of these respondents by category was:

Public companies	114
Institutional investors	14
Professional partnerships	12
Representative hodies	24
Other organisations	29
Individuals	59

The Committee would like to thank all those who have taken thr time and trouble to contribute to its work.

4 **We have been encouraged hy the response to the preliminary report,. Whilst some comment has been critical, there has been wide support for the general thrust of our views and recommendations. This consensos, building on that of Cadbury and Greenbury, is a welcome feature of the developing thinking in this field.**

1 would likc to thank al1 members of the Committee for the very considerable effort which they have devoted to our work. Particular thanks are due to the Committee's Secretary, John Healey, without whose single-minded commitment we could not have completed our task.

RONNIE HAMPEL
January 1998

1 CORPORATE GOVERNANCE

1.1 The importance of corporate governance lies in its contribution both to business prosperity and to accountability. In the UK the latter has preoccupied much public debate over the past fcw years. We would wish to ser the balance corrected.

Public companies are now among the most accountable organisations in society. Thry publish trading results and audited accounts; and they are required to disclose much information about their operations, relationships, remuneration and governance arrangements. We strongly endorse this accountability and we recognise the contribution to it made by the Cadbury and Greenbury committees. But the emphasis on accountability has tended to obscure a board's first responsibility — to enhance the prosperity of the business over time.

1.2 Business prosperity cannot be commanded. People, teamwork, leadership, enterprise, experience and skills are what really produce prosperity. There is no single formula to weld these together, and it is dangerous to encourage the belief that rules and regulations about structure will deliver success. Accountability by contrast does require appropriate rules and regulations, in which disclosure is the most important element.

1.3 Good governance ensures that constituencies (stakeholders) with a relevant interest in the company's business are fully takon into account.

In addition, good governance can make a significant contribution to the prevention of malpractice and fraud, although it cannot prevent them absolutely.

1.4 Corporate structures and governance arrangements vary widely from country to country. They are a product of the local economic and social environmcnt. We have had

the benefit of expert advice on how corporatc governance works in practice in the United States and in Germany. We have found no support for the import into the UK of a whole system developed elsewhere. But the underlying issues of management accountability are the same everywhere. There are signs that market developments may lead to convergence, with greater emphasis than before in continental Europe on 'shareholder value'. US and British pension funds and other institutional investors are increasingly investing outside their home territories, and are beginning to exercise their rights as shareholders abroad as they would at home.

1.5 The Cadbury committee — a private sector initiative — was a landmark in thinking on corporate governance. Cadbury's recommendations were publicly endorsed in the UK and incorporated in the Listing Rules. The report also struck a chord in many overseas countries; it has provided a yardstick against which standards of corporate governance in other markets are being measured.

1.6 Our remit requires us to review the Cadbury code and its implementation to ensure that the original purpose is being achieved. We are also asked to pursue any relevant matters arising from the Greenbury report. But we have an additional task, to look afresh at the roles of directors, shareholders and auditors in corporate governance. We made it clear at the outset that we would keep in mind the need to restrict the regulatory burden on companies, and to substitute principles for detail wherever possible.

1.7 We endorse the overwhelming majority of the findings of the two earlier committees. In this report we comment on matters where we take a different view, or which Cadbury and Greenbury did not deal with at all. We do not attempt to record every point of agreement. For example, we do not deal in detail with the role of the company secretary in corporate governance, because that role was fully recognised by the Cadbury committee and we have noth-

ing to add. But we do approach corporate governance from a somewhat different perspective. Both the Cadhury and Greenbury reports wcre responses to things which werc perceived to have gone wrong — corporate failures in the first case, unjustified compensation packages in the privatised utilities in the second. Understandably, both concentrated largely on the prevention of abuse. We are equally concerned with the positive contribution which good corporate governance can make.

1.8 It is too soon to reach a considered assessment of the long-term impact of the Cadbury code, but it is generally accepted that implementation of the code's provisions has led to higher standards of governance and greater awareness of their importance.

1.9 It is even more difficult to reach a definitive conclusion on Greenbury as only one set of annual reports has been produced under its guidelines. Despite the belief in some quarters to the contrary, Greenbury was not about controlling board remuneration, nor can that ever be done in a free market economy. But it is already clear that Greenbury's primary aim — full disclosure — is being achieved. Indeed, the new corporate governance requirements for the full disclosure of directors' emoluments and for a remuneration committee report have led to a disproportionate part of annual reports being devoted to these subjects.

1.10 For the most part the larger listed companies have implemented both codes fully. Smaller companies have also implemented most provisions, but there are some aspects with which they find it harder to comply. We considered carefully whether we should distinguish between the governance standards expected of larger and smallcr companies. We concluded that this would be a mistake. Any distinction by size would be arbitrary; more importantly, we consider that high standards of governance are as important for smaller listed companies as for larger

ones. But we would urge those considering thr governance arrangements of smaller listed companies to do so with flrxibility and a proper regard to individual circumstances.

1.11 Good corporate governance is not just a matter of prescribing particular corporate structures and complying with a number of hard and fast rules. There is a need for broad principles. Al1 concerned should then apply these flexibly and with common sensc to the varying circumstancrs of individual companies. This is how thr Cadbury and Greenbury committees intrnded their recommendations to be implemented. It implies on the one hand that companies should be prepared to review and explain their governance policies including any special circumstances which in their view justify departure from generally accepted best practice and on the other hand that shareholders and others should show flexibility in the interpretation of the code and should listen to directors' explanations and judge them on their merits.

1.12 Companies' experience of the Cadbury and Greenbury codes has been rather different. Too often they believe that the codes have been treated as sets of prescriptive rules. Thr shareholders or their advisers would be interested only in whether the letter of the rule had been complied with — yes or no. A 'yes' would receive a tick, hence thr expression 'box ticking' for this approach.

1.13 Box ticking takes no account of the diversity of circumstances and experience among companies, and within the same company over time. It assumes, for example, that the roles of chairman and chief executive officer should never be combined; and that there is an ideal minimum numbcr of non-executive directors, and an ideal maximum notice period for an executive director. We do not think that there are universally valid answcrs on such points. We believe, as did the Cadbury committee, that there can be guidelines which will he appropriate in rnost

cases; but that there will be valid reasons for exceptions. Where practices are approved by the board after due consideration, it is not conducive to good corporate governance for the company's explanations to be rejected out of hand and for its reputation to suffer as a result.

1.14 There is another problem with box ticking. It can he seized on as an easier option than thr diligent pursuit of corporatr governance objectives. It would then not be difficult for lazy or unscrupulous directors — or shareholders — to arrange matters so that the Ietter of every governance rule was complied with but not the substance. It might even be possible for the next disaster to emerge in a company with, on paper, a 100% record of compliance. The true safeguard for good corporate governance lies in the application of informed and independent judgement by experienced and qualified individuals — executive and non-executive directors, shareholders and auditors.

1.15 These conclusions have led us to start from the beginning and consider what is meant by corporate governance. We can accept the Cadbury committee's definition of corporate governance as 'the system by which companies are directed and controlled' (report, paragraph 2.5). It puts thr directors of a company at the centre of any discussion on corporate governance, linked to the role of the shareholers, since they appoint thc directors. This definition is of course a restrictive one. It excludes many activities involved in managing a company which may nevertheless be vital to the success of the business.

1.16 Our next step was to considcr the aims of those who direct and control companies. The single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders' investment. AII boards have this responsibility and their policies, structure, composition and governing processes

should reflect this.

A company must develop relationships relevant to its success. These will depend on the nature of the company's business; but they will include those with employees, customers, suppliers, credit providers, local communities and governments. It is management's responsibility to develop policies which address these matters; in doing so they must have regard to the overriding objective of preserving and enhancing the shareh olders' investment over time. The board's task is to approve appropriate policies and to monitor the performance of management in implementing them.

1.17 **This recognises that the director:' relationship with the shareholders is different in kind irom their relationship with the other stakeholder interests. The shareholders elect the directors. As the CBI put it in their evidence to us, the directors as a board are responsible for relations with stakeholders; but they are ac countable to the shareholders. This is not simply a technical point. From a practical point of view. to redefine the directors' responsibilities in terms of the stakeholders would mean identifying all the various stakeholder groups; and deciding the nature and extent of the directors' responsibility to each. The result would be that the dire ctors were not effectively accountahle to anyone since there would be no clear yardstick for judging their performance. This is a recipe neither for good governance nor for** corporate sucess.

1.18 This does not mean, of course. that directors must run the company exclusively in the short-term interests of today's shareholders. As we explain later, the directors' duty is to shareholders both present and future. The shareholders, many of whose holdings remain largely stable over time, are interested in a company's sustained prosperity. As regards stakeholders, different types of company will have different relationships, and directors can meet their legal duties to shareholders, and can pur-

sue the objective of long term shareholder value successfully, only by developing and sustaining these stakeholder relationships. We believe that shareholders recognise that it is in their interests for companies to do this and — increasingly — to have regard to the broader public acceptability of their conduct.

1.19 It is also important to recognise the limitations on shareholder action. Firstly, shareholders themselves are subject to constraints — they range from the smallest individual shareholders who act on their own behalf, to the largest institutional shareholder who invests third party funds, frequently under instruction, and always in a competitive environment. Secondly, shareholders cannot be denied their rights; they must be free to buy or sell as they see fit. Thirdly, shareholders by and large are not experienced business managers and cannot substitute for them. Shareholders however can and should test strategy, performance over time and governance practice, and can and should hold the board accountable provided they do this with integrity.

1.20 Having reached broad conclusions on the nature and purpose of corporate governance, we have identified a small number of broad principles — some already identified in the Cadbury and Greenbury reports — which we hope will command general agreement. In doing this we heve been mindful that business must have propcr regard to its responsibilities and to disclosure; but it is equally important to have structurcs and principles which allow businnesses to flourish and grow. We set out our suggested principles in the next chapter. These principles and what follows on other matters are dirreted largely at the proccss of corporate governance, which is our remit.

1.21 We believe, however, that it is worth repeating that process can only ever he a means, not an end in itself: it will always bc far less important for corporate success and for the avoidance of disaster than having properly informed

directors of the right calibre, bringing openness, thoroughness and ohjectivity to bear on the carrying out of their roles. It is the board's responsibility to ensure good governance and to account to shareholders for their record in this regard.

The Future

1.22 **In the** foreword to our preliminary report we said that, in response to many requests, we intended at the completion of our work to produce a set of principles and codc which embraced Cadbury, Greenbury and our work. This intention has received wide support and we shall therefore produce such a document.

1.23 We intend to pass the completed docnment to the London Stock Exchange so that it can sit alongside the Listing Rules. We believe the London Stock Exchange should then issue the document for consultation, together with any proposed changes to the Listing Rules. It is for the London Stock Exchange to determine what changes it wishes to recommend, but this committee certainly **envisages that the current requirement for companies to confirm or otherwise compliance with Cadbury will he superseded by a requirement to make a statement to show how they (i) apply the principles and (ii) comply with the combined code and, in the latter case, to justify any significant variances.**

1.24 We do not envisage that the consultation on the ncw combined principles and code will allow a re-examination of the whole subject but we share the view, widely expressed, that there must be an opportunity to eliminate any ambiguities or to seek clarification. This committee will comp1ete its work with the publication of our final report and the issue to the London Stock Exchange of the combined principles and code, but is prepared to assist the London Stock Exchange during the consultation process.

1.25 The objcctive of the new principles and code, like those of thc Cadbury and Greenbury codes, is not to prescribe corporate behaviour in detail but to secure sufficient disclosure so that investors and others can assess companies' performance and governance practice and respond in an informed way. There is, therefore, in our view no need for a permanent Committee on Corporate Governance. Thc London Stock Exchange can in future make minor changes to the principles and code.

1.26 We recognise, however that corporate governance will continue to evolve. We therefore suggest that the Financia1 Reporting Council (FRC), on which the Chairman of the London Stock Exchange, the President of the CBI and the Chairman of the Consultative Committee of Accountancy Bodies customarily sit as Deputy Chairmen, and which itself includes the Bank of England and the DTI as its sponsors, should keep under review the possible need in the future for further studies of corporate governance.

1.27 We havc consulted with the London Stock Exchange, the FRC and the DTI and the above suggestions have their support. We have reason to believe that they would also receive wide support from the other main bodies involved.

2 PRINCIPLES OF CORPORATE GOVERNANCE

2.1 We draw a distinction between principles of corporate governance and more detailed guidelines like the Cadbury and Greenbury codes. Witb guidelines, one asks 'How far are they complied with?'; with principles, the right question is 'How are they applied in practice?'. We recommend that companies should include in their annual report and accounts a narrative statement of how they apply the relevant principles to their particular circumstances. Given that the responsibility for good corporate governance rests with the board of directors, the written description of the way in which the board has applied the principies of corporate governance represents a key part of the process. We do not prescribe the form or content of this statement, which could conveniently be linked with the compliance statement required by the Listing Rules.

2.2 Against this background, we believe that the following principles can contribute to good corporate governance. They are developed further in later chapters.

A Directors

I **The Board. Every listed company should be headed by an effective board which should lead and control the company.**

2.3 This follows Cadbury (report, paragraph 4.1). It stresses the dual role of the board — leadership and control — and tbr need to be effective in both. It assumes the unitary board almost universal in UK companies.

II **Chairman and Chief Executive Officer. There are two key tasks at the top of every pblic company — the running of the board and the executive responsibility for the running of the company's business. A decision to combine these roles in one individual should be publicly explained.**

2.4 This makes it clear that therc are two distinct jobs, that of the chairman of the hoard and that of the chief executive officer. The question whether the holder should be the same person is discussed below (3.16-3.18).

III **Board Balance.** **The board should include a balance of executive directors and non-executive directors (including independent non-executive such that no individual or small group of individuals can dominate the board's decision taking.**

2.5 Cadbury highlights the need to avoid the board being dominated by one individual (code 1.2). This risk is greatest where the roles of chairman and chief executive officer are combined. But whether or not the two roles are separated, it is important that there should be a sufficient number of non-executive directors, a majority of them independent and seen to be independent; and that these individuals should be able both to work co-operatively with their executive colleagues and to demonstrate objectivity and robust independence of judgement when necessary.

IV **Supply of Information.** **The board should be supplied in a timely fashion with information in a form aud of a quality appropriate to enable it to discharge its duties.**

2.6 We endorse the view of the Cadbury committee (report, 4.14) that the effectiveness of non-executive directors (indeed, of al1 directors) turns, to a considerable extent, on the quality of the information they receive.

V Appointments to the Board. There should be a formal aud transparent procedure for the appointment of new directors **to the board.**

2.7 The Cadbury committee commended the establishment of uomination committees but did not include them in the Code of Practice. In our view adoption of a formal

procedure for appointments to the board, with a nomination committee making recommcndations to the full **board,** should be recognised as good practice.

VI Re-election. All directors should be required to submit **themselves for re-election at regular intervals and at least every three years.**

2.8 Wc endorse thr view that it is the board's responsibility to appoint ncw directors and the shareholders' responsibility to re-elect them.The "insulation" of directors from re-elcction is dying out and we consider that it **should now** cease. This will promote cffective boards and recognise shareholders' inherent rights.

B Directors' Remuneration

2.9 Directors' rcmuneration should be embraced in the corporate governance process; the way in which directors' remuneration is handled can have a damaging effect on a company's public reputation, and on morale within the company. We suggcst thc following bread principles.

I The Level and Make-up of Remuneration. **Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully. The component parts of remuneration should be structured so as to link rewards to corporate and individual performance.**

2.10 This wording makes it clear that those responsible should consider the remuneration of each director individually, and should do so against the needs of the particular company for talcnt at board level at the particular time. The remuneration of executive directors should be linked to performance.

II **Procedure.** Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual executive directors.

2.11 Cadbury and Greenbury both favoured the establishment of rcmuneration committees, and made recommcndations on their composition and on the scope of their rrmit. Thr remoneration committee is responsible to the board who have final responsibility for rcmuneration policy. But directors, whethcr executive or non-exrcutivr, should not participate in thr decisions on their own remuneration packagcs.

III **Disclosure.** The company's annual report should contain a statement of remuneration policy and details of the remuneration of each director.

2.12 This follows Greenbury (code B.l) except that it implies that the report would be in the name of the board, rather than of thc remuneration committee. This is in line with our view that remuneration policy, as distinct from decisions on individual remuneration packages for executive directors, should be a matter for the board (see 4.12).

C Shareholders

2.13 This section includes principles for applicatian both by listed companies and by shareholders.

I **Shareholder Voting**. Institutional shareholders have a responsibility to make considered use of their votes.

2.14 Institutional shareholders include intrrnally managed pcnsion funds, insurance companies and professional fund managcrs. Thr wording does not make voting mandatory, i.e. abstention rcmains en option; bnt thcsc shareholdcrs should, as a mattcr of practicc, make considered use of their votes.

II **Dialogu e between Companies and Investors.** **Companies and institutional sbarebolders sbould eacb be ready, where practicable, to enter into a dialogue based on the mutual understanding of objectives.**

2.15 **This gives general endorsement to the idea of dialogue between companies and major investors. In practice, both companies and institutions can only participate in a limited number of one-to-one dialogues.**

III **Evaluation of Governance Disclosnres.** **When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institntional investors and their advisers should give due weight to al1 relevant factors drawn to their attention.**

2.16 **This follows from the discussion in Chapter 1, paragraphs 1.11-1.14 on the importance of considering disclosures on their individual merits, as opposed to 'box ticking'.**

IV **The AGM.** **Companies should use the AGM to communicate with private investors and enconrage their participation.**

2.17 **Private investors hold about 20% of the shares in listed companies, but are able to make little contribution to corporate governance The main way of achieving greater participation is through improved use of the AGM. Wc discuss a numbcr of suggestions for this purpose later.**

D Accountability and Audit

2.18 **This section includes principles for application both by listed companies and by auditors.**

I **<u>Financia1 Reporting</u>. The board should present a balanced and understandable assessment of the company's position and prospects.**

2.19 **This follows thc Cadbury Code (4.1). It is not limited to the statutory obligation to produce financia1 statements. The wording rcfers mainly to the annual report to shareholders, but the principie also covers interim and other price-sensitive public reports and reports to regulators.**

II **<u>Internal Control.</u> The board should maintain a sound systern of interna1 control to safeguard shareholders' investment and the company's assets.**

2.20 **This covers not only financia1 controls but operational and compliance controls, and risk management, since there are potential threats to shareholders' investment in each of these areas.**

III **<u>Relationship with the Auditors</u>. The board should establish formal and transparent arrangements for maintaining an appropriate relationship with the company's auditors.**

2.21 **We support thr Cadbury recommendation (report, 4.35(a) and (b)) that al1 listed companies should establish an audit committee, composed of non-executive directors, as a committer of, and responsible to, the board. The duties of the audit committee include keeping under revicw thc scope and results of the audit and its cost-effectiveness, and the independence and objectivity of thc auditors.**

IV **External** Auditors. The external auditors should **independently report to shareholders in accordance with statutory and professional requirements and independently assure the board on the discharge of** its responsibilities under **D.I and D.11 above in** accordance with professional guidance.

2.22 This points up the dual responsibility of the auditors — the public report to shareholders on the statutory financial statements and on other matters as required by the Listing Rules; and additional private reporting to directors on operational and other matters.

3 THE ROLE OF DIRECTORS

3.1 In this chapter we deal with the responsibilities of directors, the structure and composition of the hoard, and the appointment of suitahle individuals to it. We deal with directors' rrmuneration in thc following chapter.

I Directors

A Duties

3.2 Thc basic legal duties of directors are to act in good faith in the interests of the company and for a proper purpose; and to exercise care and skill. Thesr are derived from common law and are common to all directors. The duties are owed to the company, meaning generally the shareholders collectively, hoth present and future, not the shareholders at a given point in time.

3.3 There is a view that non-executive directors should face less onerous duties than executive directors, since they will inevitably be less well inforrmed about the company's business. However, we support the retention of common duties in the interests of the unity and cohesion of the board. Where the English courts are called upon to decide whether a director has fulfilled his or her duty, they have recently tended to take into account such factors as the position of the director concerned (e.g. whether he or she is a full time executive director or a non-executive director) and the type of company. We consider this to be a hclpful recognition of the practical situation.

B Supply of Information

3.4 The effectiveness of a board (including in particular the role played by the non-executive directors) is dependent to a substantial extent on the form, timing and quality of the information which it receives. Reliance purely on what is volunteered by management is unlikely to h e enough in all circumstances and furthcr enquiries may be necessary if the particular director is to fulfil his or her

duties properly. Management has an obligation to ensure an appropriate supply of information. In addition, we endorse Cadbury's view (report, 4.8) that the chairman has a particular responsibility to ensure that al1 directors are properly briefed on issues arising at board meetings.

C Training

3.5 We agree with Cadbury that, on the first occasion that an individual is appointed to the board of a listed company, he or she should receive induction into the responsibilities of a director. It is the board's responsibility to ensure that this help is available. It is equally important that directors should receive further training from time to time, particularly on relevant new laws and regulations and changing commercial risks.

D Executive Directors

3.6 Executive directors share with their non-executive colleagues overa11 responsibility for the leadership and control of the company. As well as speaking for the business area or function for which he or she is directly responsihle, an executive director should exercise individual judgement on every issue coming before the board, in the overa11 interests of the company. In particular, an executive director other than the chief executive officer needs to be able to express views to the board which are different from those of the chief executive officer and be confident that, provided that this is done in a considered way, the individual will not suffer. Boards should only appoint as directors executives whom they judge to be able to contribute in these ways. Board appointment should not be regarded simply as a reward for good performance in an executive role.

E Non-executive Directors

3.7 The Cadbury committee raised the profile of the non-executive director, and this has been very beneficial. An unintended side effect has been to overemphasise the monitoring role. The Cadhury committee themselves recognised the danger:

> 'Thc cmphasis in this report on the control function of non-executive directors is a consequence of our remit and shoold not in any way detract from the primary and positive contribution which they are expected to make, as equal board members, to the leadership of the company'. (Report, 4.10.)

3.8 Non-executive directors are normally appointed to the board primarily for their contrihution to the development of the company's strategy. This is clearly right. We have found general acceptance that non-executive directors should have hoth a strategic and a monitoring function. In addition, and particularly in smaller companies, non-executive directors may contribute valuable expertise not otherwise available to management; or they may act as mentors to relatively inexperienced executives. What matters in every case is that the non-executive directors should command the respect of the executives and should be able to work with them in a cohesive team to further the company's interests.

3.9 The Cadbury committee recommended that a majority of non-executive directors should be indepcndent, and defined this as 'independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement' (report, 4.12). We agree with this dcfinition, and after carcful consideration we do not consider that it is practicable to lay down more precise criteria for independencc. We agree with Cadbury that it should bc for the board to take a view on whether an

individual director is independent in the above sense. The corollary is that boards should disclosc in thc annual raport which of thr dircctors are considcred to be independent and be prcparcd to justify their view if challenged. Wc recognise, however that non-executive directors who are not in this scnse 'independent' may nonetheless make a useful contribution to thr board.

3.10 Some smaller companies have claimrd that thry cannot find a sufficient, number of independent non-executive directors of suitable calibre. This is a real difficulty, but the nccd for a robust independent voice on the board is as strong in smaller companies as in large ones. In many smaller companies the executives are also major shareholders; and the leve1 of externa1 scrutiny by other shareholders and thc market is low. Non-executive dircctors do a vital job in safeguarding minority interests and ensuring good governance. We have already noted (1.10) the need to consider the governance arrangements of smaller companies with flexibility and proper regard to individual circumstances.

II The Board

3.11 Thr prime responsibility of the board of directors is to determine the broad stratcgy of the company and to ensure its implementation. To do this successfully requires high quality leadership. It also requires that thr directors have sufficient freedom of action to exercise their leadership. Tho board can only fulfil its responsibilities if it meets regularly and reasonably often.

A Structure

3.12 We have found overwhelming support for the unitary board of the typc common in the UK. There was littlc cnthusiasm for a two tier framework. The unitary board offers considcrablc flnxihility. The board may delegate functions to board committees. Audit, remuneration and nomination committees play an important rolc in

corporate governance. Some boards delegate operational decisions to an executive committee, and so adopt some of the feature sof the two tier board. In our view this is cntirely a matterr for the individual company.

B Performance

3.13 A recent report of the US National Association of Corporate Directors recommended the introduction of formal procedures by which boards would asscss both threir own collective performance and that of individual directors. Som e UK boards already operate such procedures. We believe that this is an interesting devclopment which boards might usefully consider in the interest of continuous improvement, though we do not feel able at this stag eto make a firm recommendation on the subject.

III Board Composition

A Balance

3.14 Large companies often have roughly equal numbers of executive and non-executive directors; smaller listed companies tend to have a majority of executive directors. Non-executive directors have an important part to play in corporate governance. We believe that it is difficult for them to be effective i they make up less than one third of the hoard.

B Diversity

3.15 Most non-executive directors are executives or former executives of other companies. This experience qualifies thom both in constructive policy making and in the monitoring role. Non-executive directors from other backgrounds are often appointcd for thrir technical knowledge, their knowledge of overseas markets or their political contacts. It was put to us that companies should recruit directors from a greater divcrsity of backgrounds. We do not favour divcrsity for its own sake, to

givc a politically correct appearance to the list of board members or to represent stakeholders. But we believe, given the diversity of business and size of listed companies, that therc are people from other fields who can make a real contribution on the hoard.

IV The Chairman and the Chief Executive Officer

3.16 The chairman's job was described hy Cadhury in the folowing terms:

> 'Chairmen are primarily responsihle for the working of the board, for the balance of its membership subject to board and shareholders' approval, and for ensuring that al1 directors, executive and non-executive alike, are enabled to play their full part in its activities' (report, 4.7).

The chief executive officer's task is to run the business and to implement the policies and strategies adopted by the board. There are thus two distinct roles. Subject to our view on the role of the nomination committee in board appointments (3.19 below), we endorse this description.

3.17 Cadbury recommended that the roles of chairman and chief cxecutive officer should in principle be separate; if they were combined in one person, that represented a considerable concentration of power. We agree with Cadbury's recommendation and reasoning, and wc also note that in the largest companies there may be two full-time jobs. But a number of companies have combined the two roles sucessfully, either permanently or for a time. Our view is that, other things being equal, the roles of chairman and chicf executive officer are better kept separate, in reality as well as in name. Where the roles are combined, the onus should be on the board to explain and justify the fact.

3.18 Cadbury also recommended that where the roles of chairman and chief executive officer were combined there should be a strong and independent element on the board, with a recognised senior member (code 1.2). But even where the roles of chairman and chief executive officer are separated, we see a need for vigorously independent non-executive directors. There can, in particular, be occasions when there is a need to convey concerns to the board other than through the chairman or chief executive officer. To cover this eventuality we recommend that a senior independent non-executive director — e.g. a deputy chairman or the chairman of the remuneration committee — should have been identified in the annual report. We do not envisage that this individual would for this purpose need special responsibilities or an independent leadership role, nor do we think that to identify him or her should be divisive.

V Board Membership

A Appointment

3.19 Appointment to the board should be a transparent process. Decisions should be taken, in reality as well as in form, by the whole board. We support the Cadbury committee's endorsemen of the nomination committee (report 4.30); indeed, we believe that the use of such a committee should be accepted as best practice with the proviso that smaller boards may prefer to fulfil the function themselves.

3.20 In gcncral we see the appointment of directors to represent outside interests as incompatible with board cohesion, but there may be exceptional cases where it is appropriate for a major creditor or a major shareholder to nominate a director Shareholders are, of course free to submit names for considcration by the nomination committee. Where there is a close relationship between a company and its major shareholders such suggestions may be appropriate. This is a matter for the shareholders and the company.

B Re-election

3.21 Directors of listed companies are required by the Listing Rules to submit themselvcs for election at the first AGM after their appointment. The National Association of Pension Funds (NAPF) and the Assoriation of British Insurers (ABI) expect al1 directors to submit themselves for re-election at intervals of no more than three yrars. We strongly agree and have already proposed as a principle of good corporate governance that all directors should be required to submit themselves for re-election at regular intervals of no more than three years. Wc recommend that those companies who do not as yet conform with this principle should make the necessary changes in their Articles of Association as soon as possible. We also recommend that all names submitted for election or re-election as directors should be accompanied by biographical details indicating their relevant qualifications and experience. This will enable shareholders to take an informed decision whrther to support the director's re-election

3.22 Some have proposed that companies should not disapply the statutory age limit for directors of 70; or alternatively that directors over the age of 70 should submit themselves for re-election annually. Others have suggestcd a maximum period of ten ycars' service for non-executive directors. This assumes that the effectiveness and objectivity of the director will decline with increasing age and Icngth of service. There is a risk that this could happen, and boards. and the individuals themselves, should be vigilant against il. But a reasonably long period on the board can give directors a deeper understanding of the company's business and enable them to make a morc effective contribution. Individuals' capacities, and their enthusiasm for tho task, vary widely, and a recommendation would be inappropriate.

C Resignation

3.23 There is a vicw that once a director has been elected to serve, he owes it to the shareholders to complete his term, or to givc an explanation if he is unable to do so. There are many reasons for a director's resignation which need not conccrn shareholders — health, family commitments, increased work commitments elsewhere; in these cases the privacy of thc individua1 should be respccted. But it has been suggested to us that shareholders are cntitled to know if a resignation results from a policy disagreemcnt or a pcrsonality clash. This may be helpful in appropriate cases; therc are likely to be rumours, and open disclosure may be in shareholders' interests.

4 DIRECTORS' REMUNERATION

I Introduction

4.1 **The Listing Rules implementing certain Greenbury recommendations apply to company reports for periods ending on or after 31 December 1995. They have thus been in force for only one complete reporting cycle. It is too early to judge how the Greenbury code is working in practice or to consider the case for possible changes in it. But we wish to comment on a number of points.**

4.2 **Directors' remuneration is of legitimate concern to the shareholders. They are entitled to expect that remuneration will be 'sufficient to attract and retain the directors needed to run the company successfully'; and that 'the remuneration of executive directors should link rewards to corporate and individual performance'. (Chapter 2, principle B.I.) More generally, now that details of individual directors' remuneration are disclosed, they are liable to have an impact both on the company's reputation and on morale within the company.**

II Remuneration Levels and Composition

A Levels

4.3 **The remuneration needed to attract and retain executive directors of the required calibre will be largely determined by the market. For directors of international companies, the market is increasingly global. The board, through its remuneration committee, is best qualified to judge the appropriate level; the shareholders are entitled to information which enables them to judge whether remuneration is appropriate, and whether the structure of remuneration packages will align the directors' interests with their own.**

4.4 Remuneration levels are oftcn set with the help of comparisons with other companies, including remuneration surveys. We urge caution in their use. Few remuneration committees will want to recommend lower than average salaries. There is a danger that the uncritical use of comparisons will lead to an upward ratchet in remuneration with no corrcsponding improvement in corporate performance.

4.5 Disclosure of individual director-s' remuneration has also lent force to the Greenbury recommendation that 'remuneration committees should be sensitive to the wider scene, including pay and employment conditions within the company, when determining annual salary increases' (code, C3). But it should also be recognised that ful1 disclosure of individual directors' total emoluments has led to an upward pressure on remuneration in a competitive field.

B Composition

4.6 We agree with the general view that a significant part of executive director-s' remuneration should be linked to the company's performance, whether by annual bonuses, share option schemes, or long-term incentive plans. This subject was discussed in detail by the Greenbury committee (report, 6.19.6.40), and it is clear to us that practice is still evolving quite rapidly. We are convinced that the success of such incentive schemes in stimulating performance **depends** less on the type of scheme chosen than on the detailed design of the scheme; the comparator companies; the yardstick (earnings per share, total shareholder retorn, etc.); and the quantitative relation between performance targets and benefit levels.

4.7 We have come to no general conclusion on the merits of tho various elements the remuneration package. In our view it is for the remuneration committee to ensure that the design aligns the interests of the executive

directors with those of the shareholders, and that the Iev-els of achievrement which attract benefit are rralistic but challenging. We do not, therefore, recommend further refinement of the provisions of the Greenbury code relat-ing to the form of performance-related remuneration. Instead, wc urge remuneration committees to use informed judgement in devising schemes appropriate for the specific circomstances of their company, and to bc ready to explain their reasoning to shareholders. They should ensure, as Greenbury recommended (report, 6.35), that total rewards from such schemcs are not excessive. The disclosures recommended by Greenbury will enable shareholders to monitor the arrangements in an informed way.

4.8 We considrr that payment of part of a non-cxecutive dircctor's remuneration in shares can be a useful and legitimate way of aligning the director's interests with tbose of the shareholders. We do not recommend what proportion of remuneration should be paid in this way, nor do we think that this need be universal practice. There will be some well qualified non-executive directors who, because of their personal circumstances, will need to be paid in cash. We recognise that Cadbury recom-mended that non-executive directors should not partici-pate in share option schemes in case their indcpendence was undcsirably compromised (report, 4.13). We agree. We considcr that the scale of the potential benefit arising from thc leverage inherent in the award of share options is inappropriate for non-executive directors. But We do not think that the same objection applies to the payment of non-executive remuneration in the company's shares.

III Contracts and Compensation

4.9 Grcenbury recommended that 'there is a strong caso for sctting notice or contract periods. at, or rcducing them to, one year or less while rccognising that 'in some cases notice or contract pcriods of up to two years may be

acceptable' (code, D2). Most companies have reduced director contracts from three years to two without cost to the company, and at considerable potential sacrifice to the individual. Many shareholders, however, continue to support a general reduction to one year. We agree with Greenbury that boards should set this as their objective, but we recognise that it cannot be achieved immediately, particularly where it might involve buying out existing contracts.

4.10 Much of the difficulty over compensation arises from the nced to negotiate it at the time of a director's departure, whcn relation- may be strained for othrr reasons. We note the suggestions in the Greenbury report (code, D5 and D6) on the reconciliation of the various competing considerations.

The fundamental problem lies in the fiction of the notice period. Neither party seriously expects the typical notice period required from the emptoyer under a director's service contract to be worked out. It is merely a mechanism for the payment of money. However, it is an inherently unsatisfactory mechanism because it hinges on a breach of the contract leading to damages for that breach. The damages are: (i) quantifiabte only at the time of termination; and (ii) subject to an obligation (which can be significant) to mitigate, for which it is impossible to provide a mechanical calcutation and this thcrcfore leads to uncertainty and hence controversy. A solution which brings certainty would be desirable.

This problem, and in particular the difficulty of applying the concept of mitigation in practice, is less significant in the contcxt of a general move to contracts of ene year or less. But, particularly where it is still necessary to agree a Ionger pcriod, wc see some advantage in a director's service contract whicb would make detailed provision at thn outset for tho payments to which thr director would bc entitled if at any time ha was removed from office,

except for misconduct. Such provision would be effective whether or not the director found other employment. This arrangcment would provide certainty for both sides, be operationally convenient for the employer, recognise the dislocation to the director inherent in summary dismissal, but avoid the problems of mitigation and inevitably subjective arguments about performance, conducted at the time of departure. Shareholders would of course see these provisions as they would be part of the director's service contract available for inspection.

IV The Remuneration Committee

4.11 Cadbury and Greenbury both recommended that the boards of listed companies should establish a remuneration committee to develop a policy on the remuneration of executive director-s and, as appropriate, other senior executives; and to set remuneration packages for the individuals concerned. We agree. We also agree with Greenbury that the membership of this committee should he made up wholly of independent non-executive directors. There will need to he attendance by executive directors for appropriate items.

4.12 Constitutionally, the remuneration committee is a committee of the board and responsible to the board. It is clearly wrong for executive directors to participate in decisions on their own remuneration packages, and the determination of these should be delegated to the remuneration committee. But the establishment of the bread framework of executive remuneration and its cost is in our view a matter for the ful1 board, on the advice of the remuneration committee.

4.13 We agree with Greenbury that the determination of remuneration packages of non-executive directors, including non-executive chairmen, should be a matter for the board as a whole; the individuals concerned would, of coursc, abstain from discussion of thrir own rcmuneration. It

may, however, prove convenient for the board to delegate this responsibility, case by case, to a small sub-committee, which might include the chief executive officer.

V Disclosure

4.14 Section 12.43(x) of the Listing Rules implements most of the disclosure provisions in section B of the Greenbury code by requiring companies to include in their annual report:

(a) a report by the remuneration committee on behalf of the board, covering hoth the company's remuneration policy for executive director-s; and

(b) details of the remuneration packages of each director.

Consistent with our view of the status of the remuneration committee, we consider that reports to shareholders on remuneration should be made in the name of the board as a whole.

4.15 We have reviewed the value of a general statement of remuneration policy. A number of companies have met the letter of this requirement with anodyne references to the need to 'recruit, retain and motivate' or to pay 'market rates'. We consider that a policy statement is potentially helpful, to set the context for the more detailed information; we hope that companies will provide more informative statements, drawing attention to factors specific to the company.

4.16 Remuneration disclosures are often excessively detailed, to the point where the essential features of remuneration packages have been rendered obscure to al1 but the expert reader. We welcome the recent changes to the Companies Act disclosure provisions, designed to avoid duplicating the Listing Rules. We hopc that it will he possible for thc

authoritirs concerned to explore the scope for further simplification and for listed companies themselves to present the required information in a form more accesible to the lay reader.

4.17 It was also put to us that the requirement to disclose details of individual directors' remuneration was more intrusive than regulations in force in most other countries; and that this was a disincentive to foreign nationals from accepting appointments to thr boards of UK companies. We acept that this may be so in some cases; but wc believe that shareholders havc an equal interest in disclosure of the remuneration of all directors, regardless of nationality or residence.

Pensions Disclosure

4.18 Greenbury recommended that 'also included in the report should be pension entitlements earned by each individual director during the year, calculated on a basis to be recommended by the Faculty of Actuaries and the Institute of Actuaries' (code, B.7). In their detailed discussion (report, 5.17-5.23) the Greenbury committee found that for defined contribution pension schemes the contribution paid by the company measured correctly both thr benefit to the individual and the cost to the company; but that was not true for defined benefit (final salary) schemes. In particular, pay increases shortly before retirement could greatly affect the value to the director and the long-term cost to thc company. This is not necessarily fully reflected in the level of the employer's contribution.

4.19 The Faculty of Actuaries and Institute of Actuaries recommended in April 1996 that in the case of defined benefit schemes, the company should disclose :

(a) the amount of the increase in the accrued pension to which each director became entitled during the year; and

(b) either the transfer value associated with that increase or sufficient, prescribed information to enable a reasonable assessment to be made of the value of the increase in accrued pension.

The London Stock Exchange has now issued an amendmcnt to the Listing Rules requiring disclosurc on these lines in company reports for periods ending on or after 30 June 1997. We support a requirement in these terms; and we suggcst that when making disclosures under (b), companies might spell out that thr transfer value represents a liability of the company but not a sum paid or due to the individual; and that it cannot meaningfully bc added to annual remuneration.

VI Shareholder Involvement in Remuneration

4.20 We agree with Greenbnry's recommendation that shareholders 'should be invited specifically to approve all new long term incentive plans.. which potentially commit shareholders' funds over more than one year, or dilute the equity' (code, B.12).

4.21 Greenbury recommended that the remuneration committee's report to shareholders should not be a standard itrm of agenda for AGMs; but that a view should he taken each year whether the AGM should be invited to approve tho remuneration policy. We agree that the decision whether to seek shareholder approval for the remuneration report should be one for the company. To require shareholder approval for a single aspect of company policy would, in our vicw, be inappropriate. A shareholder sufficiently unhappy with the remuneration report ultimately has the opportunity to vote against the whole of the report and accounts (see 5.20 below).

5 THE ROLE OF SHAREHOLDERS

ı Background

5.1 60% of shares in listed UK companies are held by UK institutions — pcnsion funds, insurance companies, unit and investmrnt trusts. Of the remaining 40%, about half are owned by individuals and half by overseas owners mainly institutions. It is clear from this that, a discussion of the role of shareholders in corporate govcrnance will mainly concern the institutions, particularly UK institutions.

5.2 Institutional investors are not an homogeneous group. They al1 have an overriding responsibility to their clients, but they have different investment objectives. The time period over which they seek to perform varies, as do thrir objectives for income and capital growth. Typically institutions used not to take much interest in corporate governance. They tried to achieve their target performance by buying and selling shares, relying on their judgement of the underlying strength of companies and their ability to exploit anomalies in share prices. Institutions tended not to vote their shares regularly, and to intervene directly with company managements only in circumstances of crisis.

5.3 Institutions' attitudes have changed somewhat recrntly. The proportion of shares which they own has increased, and it is more difficult for them to se1l large numbers of shares without depressing the market. Some institutions now aim to match their portfolio to the components of a share index — index tracking — which they think may have better long-term results than an active trading policy. Where an institution is committed, explicitly or de facto, to retaining a substantial holding in a company, it shares the board's interest in improving thc company's performance. As a result, some institutions now take a more active interest in corporate governance. They can do this by voting on resolutions in General Meetings, and informally through contact with the company.

5.4 A major public sector US fund, most of whose investments are passively managed, has gone further and targeted a small number of underperforming companies.

5.5 Institutions are not normally experienced business managers and cannot substitute for them. But we believe that they can take a constructive interest in, and test, strategy and performance over time.

Pension Fund Trustees

5.6 Pension funds are the largest group of institutional investors. The trustees of the fund are the owners of the shares; but in many cases they delegate the management of the investments, including relations with companies, to a fund management group. In these cases the actions of the trustees and their relations with the fund manager have an important bearing on corporate governance. It is often said that trustees put fund managers under undue pressure to maximise short-term investment returns, or to maximise dividend income at the expense of retained earnings; and that the fund manager will in turn be reluctant to support board proposals which do not immediately enhance the share price or the dividend rate. Evidence to support this view is limited (particularly in relation to dividends), but we urge trustees to encourage investment managers to take a long view.

II Institutional Shareholder Voting

5.7 Severa1 institutions have recently announced a policy of voting on al1 resolutions at company meetings. This has yrt to be reflected in a significant increase in the proportion of shares voted, which has risen only marginally in the last five years and remains at less than 40%. The right to vote is an important part of the assct represented by a share, and in our view an institution has a responsibility to the client to make considered use of it. Most votes will no doubt be cast in favour of resolutions

proposed by the board, hut it is salutary for the board to recognise that the support of the institutions is not automatic. We therefore strongly recommend institutional investors of all kinds, wherever practicable, to vote al1 the shares under threir control,according to their own brst judgement, unless a client has given contrary instructions; and our recommendation for the publication of proxy counts (5.14 (1) below) should encourage higher levels of voting by institutions. But we do not favour a legal obligation to vote. No law could compel proper consideration. The result could well be unthinking votes in favour of the board by institutions unwilling or unable to take an active interest in the company.

5.8 The ABI, the NAPF and a number of individual institutions and advisers have adopted voting guidelines. These have largely reflected the Cadbury and Greenbury codes, though some have gone further. Companies accept the right of institutions to adopt their own guidelines; but a numbcr have pointed out that some of these include different and sometimes mutually incompatible provisions. With the best will in the world, companies cannot comply with them all. We do not see how in the last resort the rights of individual institutions to set their own guidelines can be circumscribed; but we strongly urge all those concerned to take account of companies' very real difficulty, and to review thcir voting guidelines with the aim of eliminating unnecessary variations. We suggest that thc ABI and the NAPF should examine this problcm.

5.9 It has been suggested that institutions should make public their voting records, both in aggregate, in terms of the proportion of resolutions on which votes were cast or non-discretionary proxies lodged, and in terms of the numbcrs of votes east and proxies lodged on individual resolations. Institutions should, in our view, take steps to ensurc that their voting intentions are being translatcd into practice; publishing figures showing the proportion of voting opportunitics takcn would be one way of doing

this. Wc therefore recommend that institutions should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged. But an obligation on sharcholders to go further and to disclose to the world details of individual votes cast could be a disincentive to vote in some circumstances; we attach greater importance to the casting of the vote than to subsequent publicity (ser also 5.14 (b)) below).

III Dialogue Between Companies and Investors

5.10 Cadbury recommended that 'Institutional investors should encourage regular, systematic contact at senior executive level to exchange views and information on strategy, performance, board membership and quality of management' (report, 6.11). The idea of contact between companies and institutions was developed in 1995 in the report of a joint City/Industry working group chaired by Mr. Paul Myners and titled Developing a Winning Partnership. The main recommendations of this report included:

- investors to articulate their investment objectives to management;
- investors to be more open with managements in giving feedback on companies' strategies and performance;
- improvcd training for fnnd managers on industrial and commercial awareness;
- improvcd training for company managers involvcd in invcstor relations;
- meetings between companies and institutional invcstors to be propcrly prepared, with a clear and agreed agenda.

5.11 **These recommendations have been broadly welcomed by companies and investors, and we very much hope that they will he widely adopted and acted on, notwithstanding the limitations on shareholder action which we have already noted (1.19). We attach particular importance to improved business awareness on the part of investment managers the representative hodies concerned might consider how this can he prometed. But we do not recommend that either side should be required to enter into a dialogue; individual companies and investors must remain free to abstain from dialogue; and the sheer numbers on hoth sides will make comprehensive coverage impossihle.**

5.12 **There is a risk that close contact between individual companies and shareholders will lead to different shareholders receiving unequal information. In particular, price-sensitive information may he given to individual investors, depriving them of the legal right to trade the shares, but some institutions have made it clear that they are willing to be made 'insiders' in appropriate circumstances. The guidance on the handling of price-sensitive information, puhlished hy the London Stock Exchange, is helpful, in particular the recommendation that companies should have a policy on investor communication, ideally communicated to those outside the company with whom it deals, stating how the company handles price-sensitive information.**

IV The ACM

5.13 **The Annual General Meeting (AGM) is often the only opportunity for the small shareholder to be fully briefed on the company's activities and to question senior managers on both operation and governance matters. We belicve there is a real opportunity for the AGM to be made a more meaningful and interesting occasion for participants.**

5.14 We have two main recommendations for achieving this:

(a) Some companies have adopted the practice of mounting a husiness presentation with a question and answer session. We suggest that other companies whose AGMs are well attended might examine the advantages of enhancing the occasion in this way.

(h) Companies should count al1 proxies lodged with them in advance of the meeting, and, without a poll being demanded, should announce the total proxy votes for and against each resolution once it has been dealt with by the meeting on a show of hands. This will indicate publicly the proportion of total votes in respect of which proxies were lodged, and the weight of shareholder opinion revealed by those proxy votes. Publication is thus likely to encourage an increase in shareholder voting.

We considered recommending that companies should put al1 resolutions to a postal vote, and announce the results of the ballot at the beginning of the meeting. This would avoid discussion of the resolutions taking place on the false premise that debate at the meeting, followed by a vote of those present, was likely to determine the outcome. But we concluded that this migbt be seen as a move to stifle debate, and that the time was not ripe for a radical change of this kind.

5.15 We are aware of a number of other suggestions for improvements in the AGM. We have grouped them as follows.

A Changes in the Law Relating to Shareholder Resolutions; the Rights of Proxies and the Appointment of Corporate Representatives

5.16 The DTI recently consulted on proposals to facilitate the circnlation of shareholder resolutions at the company's cxpensc; to relax restrictions on the freedom of proxies to participate in AGMs; and to permit the appointment of multiple corporate representatives. These proposals were widely welcomed. Greater flexibility in these arcas will help hoth institutional and private shareholders to participate effectively.

B Procedure at Meetings

5.17 The practice of 'bundling' different proposals in a single resolution has been widely criticised, and in our view rightly. We consider that shareholders should have an opportunity to vote separately on cach substantially separate proposal. We include in this separate votes on the report and accounts and the declaration of the dividend; but we accept that a proposal for a set of changes to the company's Articles should normally be dealt with in a single resolution. A rule to this effect might conveniently be inclnded in that part of a company's Articles dealing with procedure at general meetings.

5.18 As well as allowing reasonable time for discussion at the meeting, we consider that thr chairman should, if appropriatc, also undertakc to provide the questioner with a written answer to any significant question which cannot be answcrcd on the spot.

5.19 Cadhury recommended that the chairman of the audit committec should bc available to answer questions about its work at thc AGM (report, Appendix 4, paragraph 6(f)), and Creenbury made a similar recommendation relating to the chairman of the remuneration committee: (codo, A8). It was suggested to us that the chairman of the nomination committee should make himsclf available in

the same way. We believe that it should be for the chairman of thr meeting to decide which questions to answer himself and which to refer to a colleague; but in general we would expect the chairmen of the three committees to be available to answer questions at the AGM.

5.20 Thr directors must lay before the AGM the annual accounts and the directors' report (Companies Act 1985, s.241). Most boards propose a resolution relating to the report and accounts, though this is not a legal requirement. We recommend this as best practice, which allows a general discussion of the performance and prospects of the business, and provides an opportunity for the shareholders in effect to give — or withhold — approval of the directors' policies and conduct of the company.

C Preparation and Follow-up of the AGM

5.21 We endorse the recommendation of ICSA that the Notice of the AGM and accompanying documents should be circulated at least 20 working days in advance of the meeting — i.e. excluding weekends and Bank Holidays. This would significantly help institutions to consult their clients before deciding how to vote.

5.22 It was suggested to us that companies should circulate a record of the AGM to all shareholders as soon as practicable afterwards. We are reluctant to make a recommendation which would substantially increase companies' costs, but we suggest that companies should prepare a resume of discussion at the meeting (but not a full and detailed record), together with voting figures on any poll, or a proxy count where no poll was called, and send this to share holders on request.

V Private Shareholders

5.23 Private individuals own only about 20% of the shares in listed companies directly, and only a minority of private

shareholders take an active interest in the companies in which they invest. So the impact of private shareholders on corporate governance cannot be great. Rut we believe that thosc private shareholders who do wish to exercise their rights actively should be helped to do so. Some of thc improvement we have suggested in thc AGM will contribute to this.

5.24 Wc also consider that, so far as is practicable private individuals should have access to the same information from companies as institutional shareholders. In time, as it become possible to communicate with shareholdcrs through electronc media ,companies will be able to make their presentatios to institutional investors available to a wider audience more readily. For the time being, companies who value links with private shareholders cultivate them by, for example arranging briefings for private cliet brokers and regional shareholdersemi-nars. We commend such initiatives.

5.25 The launch of CREST and the introduction of rolling settlement have made it more attractive for private investors to hold shares through nominees. This deprive sthe investors concerned of the right to vote and to receive company information, unles some special arrangemet is made. A number of companies have established their own 'in-housc nominee and use it to restore rights to private shareholdcrs. We commcd this. The ProShare Code envisaged that nominees would extend such de facto rights to private investors generally but this code has achirvcd only limited support A joint DTI/Treasury consultation document on the Corporate Governance *of Private* Shareholders, published in November 1996, discussed the adequacy of present arrangemcnt and the need for the rights of privatc shareholdcr holding through nominees to be rcinforced by statute. The Departmcnts are prescntly considcring the response to this consultation.

6 ACCOUNTABILITY AND AUDIT

I Introduction

6.1 The Cadbury committee considered the case for audit committees of the board, including their composition and role; the principal responsibilities of auditors and the extent and value of the audit; and the links between shareholders, boards and auditors. Most of Cadbury's recommrndations were well received a number have been acted on by the accountancy profession, the Auditing Practices Board and the Accounting Standards Board. Our remit does not require us to review in detail the work of these bodies in implementing the Cadbury recommendations. We therefore comment selectively.

6.2 The primary responsibility for good corporate governance rests with the directors. The statutory role of the auditors is to provide the shareholders with independent and objective assurance on the reliability of the financial statements and of certain other information provided by the company. This is a vital role; it justifies the special position of the auditors under the Companies Act. But auditors do not have an executive role in corporate governance. If the directors fall short of high standards of corporate governance the auditors may be able to identify the deficiency; they cannot make it good.

II The Audit Committee

6.3 Thr Cadbury committee recommended that 'The Board should cstablish an audit commitee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties' (code 4.3). Thry also recommended that a majority of the non-executive directors on the committee should be independent of management (report, 4.35(b)) Larger companies have implemented thr recommendations almost univrrsally, and we believc that the results have been beneficial. Audit committees have strengthened the indepcndence of

the auditors by giving them an effective link to the board; and the explicit remit of the audit committee has strengthened its members in questioning the executive directors.

6.4 **We recognise that smaller companies may find it difficult to recruit a sufficient number of non-executive directors to meet. Cadbury's preferred composition of the audit committee. We recommend shareholders to examine such cases carefully on their merits. But we do not favour relaxing the guidelines on this point by size of company.**

III The External Auditors

A The Role of the Auditors in Corporate Governance

6.5 **The basic statutory duty of the auditors is to report to the shareholders on whether the company's annual accounts are properly prepared and give a true and fair view; and on whether the directors' report is consistent with the accounts.**

6.6 **Following publication of the Cadbury and Greenbury reports, the Listing Rules now require the auditors to review the directors' statement on 'going concern' certain aspects of the director-s' statements of compliance with the Cadbury code and certain elements of the report of the remuneration committee. The Listing Rules also require directors to agree with the auditor-s the content of preliminary announcement of financial results. Finally, auditors are required by auditing standards to review other financial and non-financial information in the annual report and to report on any inconsistencies between these and the statutory financial statements ;and to report privately to the directors obscrvations on internal control resulting from the audit.**

6.7 These are extensive responsibilities; they require auditors to demonstrate their financia1 expertise and skills of ohjective enquiry, analysis and report. Directors often also requcst auditors to provide additional verification, and thr scope of this is evolving, for example in the context of half year reports. Here, we share the reservations of others that to require puhlic verification for its own sake might detract from the directors' sense of responsibility. We therefore recommend neither any additional prescribed requirements nor the removal of any existing requirements for auditor verification of governance or publicly reported information.

B Auditor Independence

6.8 Everyone concerned accepts the principle that auditors must be objective and thus remain independent from company managements. Statutory provisions, auditing standards and professional guidance al1 aim to ensure that this principle is applied in practice. We are confident that those concerned will keep these safeguards under close scrutiny and will bring in any improvements which are necessary. Our own impression is that audit firms have very strong commercial reasons for preserving an unblemished reputation for independence. But there may be a temptation to compromise on independence where an audit firm depends for a significant proportion of its income on a single audit client. We suggest that thr bodies concerned should examine whether, in the existing professional guidance, the 10% limit of total income from one listcd or other public interest client should be reduced.

6.9 Thr audit committee is an esscntial safeguard of auditor independence and objectivity; we suggest that it should kcep under rcvicw the overall financia1 relationship between thc company and the auditors. In particular, the audit committee should have a key role where the auditors also supply a suhstantial volume of non-audit

services to the client. We suggest that the committee should keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity with value fo money.

IV Internal Controls

6.10 **Cadbury recommended that 'the directors should report on the effectiveness of the company's system of internal control' (code, 4.5) and that this report should he reviewed hy the auditors (code, footnote). This left open the questions to whom the auditors should report, and whether their findings were to he made public. Cadbury also recommended the accountancy profession to take the lead in developing criteria for assessing effectiveness and in developing guidance hoth for directors and auditors to assist in reporting on internal control (report, 5.16). The accountancy profession estahlished a working group to develop criteria for assessing effectiveness, and guidance for directors on reporting; this group reported in Decemher 1994. The Auditing Practices Board took on the task of developing guidance for auditors, and issued a discussion paper in April 1995.**

6.11 **The word 'effectiveness' has proved difficult hoth for directors and auditors in the context of pubilc reporting. It can imply that controls can offer ahsolute assurance against misstatement or loss; in fact no system of control is proof against human error or deliberate override. There has also been concern that directors or auditors who confirmed the effectiveness of a company's control system may he exposed to legal liability if unintentional misstatement or loss of any kind is found to have occurred. The report of the working group therefore recommended that the directors' statement should acknowledge the hoard's responsihility for the internal financial control system, hut explain that such a system could provide only reasonahle assurance against material misstatement or loss; should describe the key procedures established in order to provide effective financial**

controls; and should confirm that the directors had reviewed thc system's effectiveness. Directors were also encouraged, hut not required to, state their opinion on the effectiveness of their system of interna1 financia1 control. Relatively few companie have done this.

6.12 It has been suggested that point 4.5 of the Cadbury code should be amended to read 'The directors should report on the company's system of interna1 control' — i.e. dropping the word 'effectiveness'. This would not require any change to the minimum requirements of the working group's guidance -the directors would still need to review the system's effectiveness. This would recognise what is happening in practice and seems eminently sensible. We believe that auditors should not be required to report publicly on directors' statements, but that they can contribute more effectively by reporting to directors privately. This would enable a more effective dialogue to take place; and allow best practice to continue evolve in the scope and nature of such reports, rather than externally prescribing them.

6.13 The working group's guidance refers to interna1 financia1 control, defined as internal controls over the safeguarding of assets, the maintenance of proper accounting records and the reliability of financia1 information used within the busines or for publication. But the guidance also encouraged directors to review and report on al1 aspects of interna1 control, including controls to ensure effective and efficient operations and compliance with laws and regulations We accept that it can be difficult in practice to distinguish financia1 from other controls; and we believe that it is important for directors and management to conside ral1 aspects of control. We are not concerned only with the financial aspect of governance and we fully endorse the Cadbury comment that interna1 control is a key aspect of efficient management. Dircctors should therefore maintain and review controls addressing al1 relevant control objectives. These should include

business risk assessment and response, financia1 management, compliance with laws and regulations and the safeguarding of assets, including minimising thc risk of frand.

6.14 Cadhury regarded it as good practice for companies to set up an internal audit function to help discharge thesc responsibilities but did not refer to this in thr code We see no need for a hard and fast rule here But we suggest that companies and particularly audit committees, should review from time to time the need f'or a separate interna1 audit function. The work of the externa1 auditors, important though it is, will not necessarily cover the full scope of the controls.

6.15 Directors and management must always have the main responsihility for an effective system of controls. The right control environmet and 'tone from the top' is an important element of this.

v Accounting Standards

6.16 Accounting principle and the content of financia1 statements are regulated hoth by the law and hy accounting standards. The Cadhury committee drew attention to weaknesses which then existed in financia1 reporting and endorsed the ohjectives of the then newly established Financia1 Reporting Council and the Accounting Standards Board in setting reporting standards. Cadhury also welcolmed the actions of the Financia1 Reporting Reviesw Panel in monitoring compliance. These bodies are making good progress We note that there are now moves towards thc international harmonisation of accounting standards. However wc do not consider that our remit recluires us to review these arcas, in which the accounting authorities are closely involvcd.

VI Going Concern

6.17 Cadbury recommended 'that the directors should state in the report and accounts that the busines is a going concern, with supporting assumptions or qualifications as nccessary; that thc auditors should report on this statement; that the accounting profession ... should take the lead in developing guidance for companies and auditors, and that the question of legislation should be decided in the light of experience (report, 5.22). Guidance was developed by a working group set up by the accountancy profession and issue in November 1994. We understand that directors in preparing 'going concern' statements and auditors in reporting on them have found the guidante satisfactory, and we see no need for legislation.

6.18 It has been put to us that accounting standards already require directors either to prepare accounts on a going concern basis or to explain any alternative basis which they consider appropriate; a separate 'going concern' stateme is therefore strictly unnecessary. There may be some logic in this, but the present requirement obliges directors to focus on whether the company is properly regarded as a going concern; we would not wish to recommend the removal of the requirement and thus to risk downgrading the importance of 'going concern'. Economic conditions in the UK are currently favourable but in the event of a downturn the requirement for a public statement in respect of going concern will play an irnportant part in maintaining good corporate governance practices.

VII Auditors' Liability

6.19 In this report we do not propose any change in the role of auditors or their public reporting responsibilities. We feel that bcst practice should be allowed to develop and evolve. It is clcar, howevcr that while boards often seek grcater reassurancc about controls and other matters, auditors feel inhibited in going beyond thcir present

functios because of concerns about the present law on professional liability. We consider that account should be taken of these concerns by those setting professional standards and when decisions on changes in the relevant law are taken.

7 SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

Principles of Corporate Governance

1 We recommend that companies should include in their annual reports a narrative account of how they apply the broad principles set out in Chapter 2 (2.1).

Application of the Principles

2 Companies should be ready to explain their governance policies, including any circumstances justifying departure from best practice; and those concerned with the evaluation of governance should apply the principles in Chapter 2 flexibly, with common sense, and with due regard to companies individual circumstances (1.11). 'Box ticking' is ncither fair to companies nor likely to be efficient in preventing abuse (1.12-l. 14).

The Future

3 We intend to produce a set of principles and code of good corporate governance practice, which will embrace Cadbury and Greenbury and our own work. We shall pass this to the London Stock Exchange. We suggest that the London Stock Exchange should consult on this document, together with any proposed changes in the Listing Rules (1.23).

4 We envisage that the London Stock Exchange will in future make minor changes to the principles and code; and we suggest that the Financia1 Reporting Council should keep under review the possible need for further studirs of corporate governance. Rut we see no need for a permanent Committee on Corporate Governance (1.25 -1.26).

Directors

5 Executive and non-executive directors should continue to have the same duties under the law (3.3).

6 Managememt has an obligation to provide the hoard with appropriate and timely information and the chairman has a particular responsibility to ensure that al1 directors are properly briefed. This is essential if the board is to hc effectivc (3.4).

7 An individual should receive appropriate training on the first ocassion that heeor she is appointed to the board of a listed company and subsequently as necessary (3.5).

8 Boards should appoint as executive directors only those executives whom they judge able to take a broad view of the company's overa11 interests (3.6).

9 The majority of non-executivr director-s should he independent and hoards should disclose in the annual report which of the non-executive director-s are considered to he independent (3.9). This applies for companies of al1 sizes (3.10).

10 There is overwhelming support in the UK for the unitary hoard, and virtually none for the two tier board (3.12).

11 We suggest that boards should consider introducing procedures for assessing their own collective performancc and that of individual director-s (3.13).

12 We consider that, to be cffective non-executive director-s need to make up at lrast one third of thr membcrship of thr board (3.14).

13 We believe that people from a wide range of backgrounds are able to make a real contribution as non-executive directors (3.15).

14 Separation of the roles of chairman and chief executive officer is to be preferred, other things being equal, and companics should justify a decision to combine thr roles (3.17).

15 Whcthrr or not the roles of chairman and chief executive officer arc combined, a senior non-executive dirretor should be identified in the annual report, to whom concerns can be convcyed (3.18).

16 Companies should set up a nomination committee to make recommrndations to the board on all new board appointments (3.19).

17 All directors should submit themselves for re-election at least every three years, and companies should make any necessary changes in their Articles of Association as soon as possible (3.21).

18 Names of directors submitted for re-election should be accompanied by biographical details (3.21).

19 Therr should be no fixed rules for the length of service or age of non-executive directors: but there is a risk of their becoming less cfficient and objective with length of service and advancing age, and boards should be vigilant against this (3.22).

20 It may bc appropriate and helpful for a director who resigns beforc the expiry of his term to give an explanatiou (3.23).

Directors' Remuneration

21 We urge caution in tho use of inter-company comparisons and remuneration surveys in setting levels of directors' remuneration (4.4).

22 We do not rccommend further refinement in the Greenbury code provisions relating to performance related pay. Instead we urge remuneration committees to use their judgement in devising schemes appropriate for the specific circumstances of the company. Total rewards from such schemes should not be excessive (4.7).

23 We see no objection to paying a non-executive director's remuneration in the company's shares, but do not recommend this as universal practice (4.8).

24 We consider that boards should set as their objective the reduction of directors' contract periods to one year or less but recognise that this cannot be achieved inmediately (4.9).

25 We see some advantage in dealing with a director's early departure by agreeinng in advance on the payments to which he or she would be entitled in such circumstances (4.10).

26 Boards should establish a remuneration committee, made up of independent non-executive directors, to develop policy on remuneration and devise remuneration packages for individual executive directors (4.11).

27 Decisions on the remuneration packages of executive directors should be delegated to the remuneration committee; the broad framework and cost of executive remuneration should be a matter for the board on the advice of the remuneration committee (4.12). The board should itself devise remuneration packages for non-executive directors (4.13).

28 Thr requircment on directors to include in the annual report a general statement on remuneration policy should be retained. We hope that these statements will be made more informative (4.15).

29 **Disclosure of individual remuneration packages should he retained; hut we consider that this has become too complicated. We welcome rccent simplification of the Companies Act rules; and we hope that the authorities concerned will explore the scope for further simplification (4.16).**

30 **We consider that the requirement to disclose details of individual remuneration should continue to apply to overseas based directors of UK companies (4.17).**

31 **We support the requirement to disclose the pension implications of pay increases which has been included in the Stock Exchange Listing Rules. We suggest that companies should make clear that transfer values cannot meaningfully be aggregated with annual remuneration (4.19).**

32 **We agree that shareholder approval should be sought for new long-term incentive plans (4.20); hut we do not favour obliging companies to seek shareholder approval for the remuneration report (4.21).**

Shareholders and the AGM

33 **We recommend pension fund trustees to encourage fund managers to take a long view in managing their investments (5.6).**

34 **We believe that institutional investors have a responsibility to their clients to make considered use of their votes; and we strongly recommend institutional investors of al1 kinds, wherever practicable, to vote the shares under their control. But we do not recommend that voting should be compulsory (5.7).**

35 **We suggest that the ABI and the NAPF should examine the problem caused by the existence of diffcrent and incompatible shareholder voting guidelines (5.8).**

36 **We recommend that institutions should make available to clients, on request, information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged (5.9).**

37 **We encouragc companies and institutional shareholders to adopt as widely as possible the recommendations in the report Developing a Winning Partnership (5.11).**

38 **Companies whose AGMs are well attended should consider providing a business presentation at tbe AGM, with a question and answer session (5.14(a)).**

39 **We recommend that companies should count al1 proxy votes and announce the proxy count on each resolution after it has been dealt with on a show of hands (5.14(b)).**

40 **We hope that the DTI will soon be able to implement their proposals on the law relating to shareholder resolutions, proxies and corporate representatives (5.16).**

41 **We consider that shareholders should be able to vote separately on cach substantially separate issue; and that the practice of 'bundling' unrelated proposals in a single resolution should cease (5.17).**

42 **The chairman should, if appropriate, provide the questioner with a written answer to a significant qurstion which cannot be answered on the spot (5.18).**

43 **The decision on who should answer questions at the AGM is one for thr chairman; but we consider it good practice for the chairmen of thc audit, remuneration and nomination committees to be available (5.19).**

44 **Companies should propose a resolution at the AGM rclating to the report and accounts (5.20).**

45 **Notice of the AGM and related papers should he sent to shareholders at least 20 working days before the meeting (5.21).**

46 **Companies may wish to prepare a resumé of discussion at the AGM and make this available to shareholders on request (5.22).**

47 **We commend the practice of some companies in establishing in-house nominees, in order to restore rights to private investors who use nominees; and we note that the DTI and the Treasury are considering changes in the law for the same purpose (5.25).**

Accountability and Audit

48 **Each company should establish an audit committee of at least three non-executive directors, at least two of them independent (6.3). We do not favour a general relaxation for smaller companies, but recommend shareholders to show flexibility in considering cases of difficulty on their merits (6.4).**

49 **We do not recommend any additional requirements on auditors to report on governance issues, nor the removal of any existing prescribed requirements (6.7).**

50 **We suggest that the bodies concerned should consider reducing from 10% the limit on the proportion of total income which an audit firm may earn from one audit client (6.8).**

51 **We suggest that the audit committee should keep under review the overa11 financia1 relationship between the company and its auditors, to cnsure a balance between the maintenance of objectivity and value for money (6.9).**

52 **We recommend that the word 'effectiveness' should be dropped from point 4.5 in the Cadbury code, which**

would then read 'The directors should report on the company's system of interna1 control'. We also recommend that the auditors should report on interna1 control privately to the directors, which allows for an effective dialogue to take place and for best practice to evolve (6.12).

53 **Directors should maintain and review controls relating to al1 relevant control objectives, and not merely financia1 controls (6.13).**

54 **Companies which do not already have a separate interna1 audit function should from time to time review the need for one (6.14).**

55 **The requirement on directors to include a 'going concern' statement in the annual report should be retained (6.18).**

56 **Auditors are inhibited from going beyond their present functions by concerns about the law on liability. Account should be taken of these concerns by those responsible for professional standards and in taking decisions on changes in the law (6.19).**

ANNEX

A Membership of the Committee on Corporate Covernance

The report is issued in the names of the following members of the committee:

Sir Ronald Hampcl (Chairman, ICI *plc) — Chairman*
Michael Coppel (Chairman, *Airsprung Furniture Group plc)*
Michael Hartnall (Finance *Director, Rexam plc)*
Giles Henderson CBE (Senior *Partner, Slaughter and May)*
Sir Nigel Mohhs *(Executive Chairman, Slough Estates plc)*
Tony Richards TD *(Director, Henderson Crosthwaite Ltd.)*
Tom Ross *(Principal and Actuary, Aon Consulting Limited)*
Peter Smith *(Chairman, Coopers & Lybrand)*
David Thomas *(Director and General Manager (Investments), The Equitable Life Assurance Society)*
Sir Clive Thompson *(Chief Executive, Rentokil Initial plc)*

John Healey — *Secretary*

Lord Simon of Highbury (previously Sir David Simon CBE, Chairman of British Petroleum plc) was a member of the committee from its estahlishment until 7 May 1997, when he resigned on his appointment as a Government Minister.

Christopher Haskins (Chairman of Northern Foods plc) was a member of the committee from its establishment until the publication of the committee's preliminary report in August 1997, when he resigned following his appointment as Chairman of the Better Regulation Task Forte.

B The Committee's Remit

Thr committee's remit was agreed with the sponsor organisations – the London Stock Exchange, the Confederation of British Industry, thr Institute of Directors, the Consultative Committee of Accountancy Bodies the National Association of Pension Funds and thr Association of British Insurers.

The terms of thc remit wcre as follows:

> 'The committee will seek to promote high standards of corporate governance in the interests of investor protection and in order to preserve and enhance the standing of companirs listed on the Stock Exchange. The committee's remit will extend to listed companies only.
>
> Against this background the committee will:
>
> (a) conduct a review of the Cadbury code and its implementation to ensure that the original purpose is being achieved, proposing amendments to and deletions from the code as necessary;
>
> (b) keep under review the role of directors, executive and non-executive, recognising the need for board cohesion and the common legal responsibilities of all directors;
>
> (c) be prepared to pursue any relevant matters arising from the report of the Study Group on Directors' Remnneration chaired by Sir Richard Greenbury;
>
> (d) address as necessary the role of shareholders in corporatc governance issues;
>
> (e) address as necessary the role of auditors in corporate governance issues; and
>
> (f) dcal with any other relevant matters.
>
> Without impairing investor protection the committee will always keep in mind the need to restrict the regulatory borden on companies, e.g. by substituting principles for detail wherever possible.'