

Allen Sykes
Tel. Leatherhead
(0372) 375851
Fax (0372) 362693

CAD-02141
Mallington
29 The Mount
Fetcham, Leatherhead
Surrey KT22 9EB

Sir Adrian Cadbury
Committee on the F:
of Corporate Gov:
PO Box 433
Moorgate Place
London EC2 2BJ

Sir Adrian

Shall I acknowledge, & decline the
invitation on page 2, on your behalf?

Dear Sir

N.J.L.
20/7

Comments on the Draft Report

I much enjoyed and appreciated our 25 June meeting at the Bank of England to discuss your Committee's 27 May Draft Report. Tony Merrett has written to you separately on our auditing proposals. I said I would let you have my summary comments, along the lines we discussed, on the more general matters covered in my separate submission. This is attached. I regret it has taken me nearly three weeks, but I have been almost continually in North America on three separate trips since we last met, hence the delay.

I have set out my main comments and recommendations as briefly as possible. I have also included a few short comments on certain of the Committee's recommendations on Shareholders.

Your Committee, while giving itself a wide-ranging brief (see in particular your Paragraph 1.1) is called the Committee on the Financial Aspects of Corporate Governance. As we discussed, however, the more I study the matter the more I feel the problems of auditing, remuneration, etc. require the same changes in how boards are appointed and how owners perform their responsibilities as do the raising of long term corporate efficiency. Both sets of problems require truly independent directors appointed and helped by shareholders. This is as true of effective audit and remuneration committees as it is of raising long term efficiency. Both require owners to discharge their

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14 July 1992

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responsibilities. The whole subject is really indivisible as I hope I bring out clearly in the attached comment. I hope, therefore, that you and your colleagues will feel able to acknowledge the link and to urge further work in overcoming the iron grip of short termism on so much of the business sector.

I promised to let you have a copy of a letter published in the Times (Business Section) last Autumn after the death of Robert Maxwell. It was by a businessman recalling an incident in Robert Maxwell's office in the mid 1970s. The auditors were present and sought Maxwell's permission and funding to investigate some suspicious matter. His reply was that he did not want the matter investigated, no funds would be forthcoming, and if the auditors persisted he would sue them for defamation. The auditors backed down. I cannot find the letter but the Times clipping service could get it for you, and any reply although I recall none.

Finally, the Major Projects Association of 70 major British and foreign companies is holding its one day annual conference in London on 29 October. The subject is 'Overcoming the Short Term Bias in Decision Taking, Nationally and Internationally'. There will be a senior audience of 100 - 120 from Britain, plus numerous senior corporate, government and EEC representatives from Europe, and a few from Japan and the United States. Sir Alistair Frame, our Chairman, is chairing the conference and we shall have numerous distinguished speakers, mostly senior international businessmen, plus Sir Leon Brittan and Walter Eltis. It promises to be an important and practical occasion for senior people to debate a subject now recognised as of the first importance. If you are free and interested we would welcome your attendance.

With kind regards

Yours sincerely



A handwritten signature in cursive script, appearing to read 'C. Allen', is written above a horizontal line that extends to the right.

14 July 1992

COMMENTS ON THE 27 MAY DRAFT REPORT ON THE CADBURY COMMITTEE
ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

by Allen Sykes

1. Introduction

In Paragraph 1.1 of the Draft Report the Committee states the setting for its report in the following terms:-

'The country's economy depends on the drive and efficiency of its companies. Thus the effectiveness with which their boards discharge their responsibilities determines Britain's competitive position. They must have the freedom to drive their companies forward, but to exercise it within a framework of effective accountability. This is the essence of any system of corporate governance.'

It is against this clear statement, which I fully support, that I have framed my comments. I deal briefly with the three major changes which I consider necessary to overcome the severe corporate governance handicaps which presently exist for British companies, particularly those in manufacturing, high technology and construction industries. These changes concern the ownership vacuum, the remuneration and incentives of senior management, and the terms on which investment institutions employ fund managers. Second, in a separate attachment, I comment briefly on some of the Committee's detailed proposals for Shareholders, in Section 6 of the Draft Report. All my comments need to be read in conjunction with my original paper to the Committee of March of this year.

2. Three Recommended Minimum Changes

a) The Ownership Vacuum

At present there is a serious power vacuum at the heart of British corporate governance in that the ownership function largely goes by default. Individual shareholders (20%) in practice are powerless to affect the major decisions of the companies in which they invest. (See in particular Section 3 a) of my 1990 David Hume paper - reference 6 in my March submission to the Committee.) Their shareholdings are small and fragmented, and their influence is negligible.

The investment institutions (70%) have the potential to exercise a major ownership role but in practice are passive. They typically take little or no part in corporate governance save in a crisis or a threatened takeover bid. In particular, they seldom make any

attempt to appoint non-executive directors. The investment institutions are in fierce competition with each other to attract and retain investment funds, and wish to maintain the freedom to chop and change shareholdings at short notice. (This freedom, as I have pointed out, is largely illusory.) If they detect unfavourable developments in a company their usual wish is to sell out, or at least reduce their holding. It is not to seek to change the company for the better, in stark contrast to our much more successful competitors in Western Europe and the Pacific Rim.

The actions of the two main classes of shareholders means that the ownership function is seldom discharged in British companies, hence management is largely non-accountable in practice, thus flouting one of the key requirements of the Committee. Boards of directors in consequence are necessarily self perpetuating. The Chairman and perhaps CEO choose the non-executive directors, or in John Kay's telling phrase '... the monitored appoint the monitors'. This means that until the investment institutions either fulfil the ownership role directly, or procure this role by either sharing it (the essence of my main proposal) or investing in investment intermediaries who will discharge the role, the vacuum will remain. The existence of truly independent directors, the underlying requirement for all the Committee's main recommendations, will not be achieved. Unless this basic point is addressed in the final report it is difficult to see how the Committee's main aims will be achieved.

b) Management Remuneration

The Committee is rightly concerned in the matter of the remuneration of executive directors and senior management. It calls, quite properly, for board remuneration committees comprised wholly or mainly of non-executive directors. But carrying out this recommendation under the present system of corporate governance will always be unsatisfactory for two reasons. First, non-executive directors owe their appointment, their likely re-appointment, and their own remuneration to the Chairman and some of his or her executive director colleagues, and so can never be seen to be totally independent. (This is no slur on present non-executive directors, of whom I am one, most of whom do act independently when they sit on remuneration committees. Most of the abuses, however, have come when such independence was not exercised for whatever reasons.) Further, very independent minded non-executive directors are, under our present system, unlikely to be appointed to other boards.

Second, because the ownership function is seldom discharged, the pressures for short term decisions on directors is strong. Accordingly, remuneration packages for achieving long term performance are rare. This will always be the case under our present system. What should be the prime motivation for internationally competitive, long term performance is simply not on offer under our system of corporate governance. This vital matter is comprehensively addressed by my proposals which simultaneously result in the ownership role being discharged by knowledgeable, independent directors appointed by shareholders, and setting executive directors remuneration packages in the context of five year performance targets, while always holding such directors fully accountable. Something along these lines would seem to fulfil the Committee's aims more satisfactorily than the present draft recommendations.

c) Fund Management Employment Terms

A few years ago investment institutions (including, let it be said, company pension fund trustees) used to appoint fund managers for only 2 - 3 years, a term much too short to ensure long term performance. This unsatisfactory period has since been widely shortened and is sometimes little more than 12 months. Inevitably this results in fund managers trying to impress their clients over the short period of their appointment. In turn, they put pressures on companies for short term performance which must be at the expense of longer term achievement. As a result our research and development expenditures are far lower than our main overseas rivals, long term capital expenditures suffer, and there is a natural and very strong temptation to accept the 40% plus takeover premiums frequently available regardless of whether a takeover is justified long term. As I have repeatedly stressed, it is this mechanism which institutionalises short termism in our system. It is a grave handicap to international competitiveness, particularly in those vital industries in which Britain has been in relative decline for over thirty years, namely manufacturing, high technology and construction.

It is necessary to reverse this situation by appointing fund managers for more relevant longer terms, albeit subject to safeguards. It is hard to see how this would come to pass unless the ownership vacuum is overcome. It needs to be remembered, however, that the ultimate beneficiaries of investment institutions (see Section 3 a) of my March paper) are all interested in investment time horizons of 5 to 15 years, and most typically 8 to 10 years. The investment institutions are not discharging their responsibilities in the best interests

of those providing the underlying funds. Nor can they do so until, between themselves, they address the ownership vacuum which is the fundamental weakness of our present system of corporate governance.

3. Conclusions

Our system of corporate governance fails to satisfy the long term interests of both managers and the ultimate long term owners of the funds invested in companies. This is not the fault of any one party, rather it is a system fault. Until widely recognised as such no fundamental improvements are possible, because the changes need to be integrated. I do not for a moment believe my own integrated proposals are either the only ones, or necessarily the best that could be devised. Indeed, if my underlying analysis is accepted, I would hope others could and would improve upon them. I claim only that they do address all the fundamental weaknesses of our present system of corporate governance and would simultaneously ensure accountability, long term international competitiveness, and much higher long term returns to investors. But I hope I have shown that the basic problems of corporate governance will not yield to piecemeal solutions.

I will finish this brief comment with the statement which began and ended my March submission. 'There are no generally successful systems of corporate governance without committed and knowledgeable long-term shareholders, managements with the preconditions and incentives for long term performance, and with such managements being properly accountable to their shareholders.' In Britain, we presently lack all three of these interrelated requirements.

A handwritten signature in dark ink, consisting of stylized, overlapping letters that appear to be 'C' and 'H'.

ATTACHMENT A

SOME BRIEF COMMENTS ON SECTION 6 ('shareholders') OF THE
27 MAY, 1992 DRAFT REPORT ON THE CADBURY COMMITTEE

by Allen Sykes

The selective comments below should be read in conjunction with my separate paper of recommendations to the Committee.

- 6.1 In theory, shareholders select boards of directors of public companies. In practice, institutional shareholders do not discharge this function and individual shareholders cannot. Hence boards are of necessity self perpetuating. The formal relationship of boards of directors and companies is contrary to the reality.
- 6.2 The Committee has not been persuaded that shareholders should have a closer involvement in the appointment of directors via shareholder committees since they might not be truly representative and in regular touch with their constantly changing constituencies. I agree, but my proposals (and probably others) do overcome these difficulties. If the difficulties cannot be overcome major beneficial change would seem highly unlikely. How, under the present system, is the Committee's hope for 'direct' influence to be achieved?
- 6.3 Shareholders, disorganised and disparate, cannot hold boards generally accountable - that is one of the major problems. The recommended code is an improvement, but not a fundamental one. Accountability is unlikely to be much strengthened.
- 6.4 AGM's are indeed usually 'opportunities missed', but will the Committee's recommendations lead to major change? It is hard to see how and why this should happen unless the ownership vacuum is overcome.
- 6.7 A most important comment. Institutional shareholders must assume the ownership responsibility for assuredly, if they do not, no one else can.
- 6.8 The Committee welcomes, as do I, the recently published statement by the Institutional Shareholders Committee. I believe, however, that the good intentions expressed will not have the desired effect unless the ownership vacuum is filled. This requires the institutions to share (my proposal) or procure the ownership role.

1. Systematic contact with even the top 100 public companies by the 60 main investment institutions will necessarily be superficial. The task must either be shared or delegated.
 2. Voting rights at AGM's are no substitute for appointing knowledgeable independent shareholder directors as set out in my proposals.
 3. Agreed - but this role has not been discharged to date. To be effective it must be organised, i.e. the institutions must co-operate. But even if they were to co-operate in the appointment of independent non-executive directors, they would lack the power, support and knowledge inherent in my proposals for shareholder directors.
- 6.10 My proposals deal fully and I believe satisfactorily with the problem of investment institutions being made 'insiders'. At worst, investors would only use their freedom to invest in the tiny minority of companies in which they invest (8% in my proposals for the top 100 companies) in return for almost certainly much enhanced long term investment returns across their whole portfolios. I submit that this is a sacrifice well worth making for all concerned, and not least the underlying owners of the investment funds.
- 6.11 In practice any significant long term relationship involves the sharing or delegation of the task.
- 6.13 The backing for reforms by the institutions and in particular the Institutional Shareholders Committee is indeed vital. Nothing useful is possible without their enthusiastic support. If that cannot be obtained Britain must settle for continued, relative economic decline.

