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cc Sir Adrian

Arch'd.

N Peace Esq
Secretary, Committee on the Financial
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11th July 1992

Dear Mr Peace

Committee on the Financial Aspects of Corporate Governance

Thank you for sending a copy of the report. That Sir Adrian should have suffered so close a loss stirred great sympathy.

The Draft Report does, I think, strike an admirable balance. You have included nothing with which I would wish to disagree and I offer congratulations. As you invite comments I review my earlier point and, with regret, add 2 other comments.

Small Shareholders

I wrote to you with the small shareholder much in mind and prompted by Mountleigh and Tranwood. I accept though, that small shareholders can be a nuisance by being difficult to focus, and information in their hands can put business strategy at risk. Corporate failure in developmental stage ought, though, to be made more visible to shareholders. The improved reporting which the Committee recommends at the interim stage will improve visibility but by the time the publication is with shareholders, the year is too far advanced. And unless forced to, many boards will not in these circumstances communicate with shareholders. **It would be helpful if in addition to recommendation (8), that the Committee's sponsors should in two years' time consider the inclusion of cash flow information at the interim stage, for the possibility also to be considered by the sponsors for the introduction of a more accessible facility for organised dialogue in mid trading year between directors and shareholders.**

Going Concern

The Report works on "going concern" in the Code from the Audit angle and by demanding that directors, where appropriate, should name "going concern" as the basis of preparation of their accounts.

The Lloyds Bank's takeover threat against Midland Bank was reminiscent of the asset stripping days of the early 1970s; but Lloyds management really had no choice in proposing a bid and the Board had no reason to oppose the recommendation. The MMC referral threat worked with just the right effect. The drama was a cause for concern, sadly expensive but ethically sound and for the commercial life as a whole, beneficially edifying save for the unfairly advantageous position in which Lloyds now stands vis-a-vis Nat West & Barclays.

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At the Midland's 1991 year-end (latest) AGM, Sir Peter Walters (whose role I suggest deserves only approbation) said "....the interests of shareholders, customers and staff, in no particular order...". There is here a dilemma which I hope the Committee's report could yet address because it has very much to do with "going concern" for companies, and consequently with the common wealth of businesses of the UK.

Shareholders should support business and to take Midland as an example, its first object is "to carry on .... the business of banking ....". The first power and duty of Midland's directors is "The business of the Company shall be managed by its directors ...", all quite in common with many other companies.

Would the Committee agree that Sir Peter could have said ".... Customers, Shareholders and Staff, in that order ...."? In 1993, could this be said with backing such as the Commitee's Code?

<u>I would suggest that it be extended slightly and re-cast as a recommended Article of Association to read:</u>
<u>**"The directors have the duty to manage the Company's business as a going concern. The directors shall give priority of their consideration to trade and to the turnover of the business in any current and and for the next following year and shall then consider in this order first the interests of the providers of capital employed by the Company, then the interests of their Employees and then the interests of their Creditors and Suppliers provided always that "consideration" in this Article applies to discretion available to the directors subsequent to the fulfilment by them and by the Company of any and all obligations. This article shall be suspended if the directors feel obliged to and do recommend that the Company should cease trading."**</u>

This Article would not be advised for a company which writes Pension or Life Assurance business or is an investment company (as defined by S130 Income & Corporation Taxes Act 1988).

Would the committee agree to recommending a change to Articles of Association as a second prong to their assault on the doubts dogging "going concern"?
I should like to advance this draft Article for the Committee's consideration and failing that for consideration for the review at the two year stage.

<u>Takeovers</u>

Directors often find themselves in a quandary. They will probably consult with major shareholders, but distance themselves excessively from the majority whose views remain unknown. The Midland example is interesting. I submit Annex 1.

<u>Fraud</u>

Were the Committee able to get into the mind of the fraudster, and thus to feel that the activities of such are likely to be discouraged in future? There are other fraudsters about. Big frauds have only become apparent after money (other peoples' money) has run out. The suspected fraud in the Maxwell companies has greatly extended **since** the Committee put its recommendations on paper. **Teeth that really look frightening are needed and this Committee can, and I venture to suggest should, recommend them.** The need to form an Audit Committee works too slowly. Could the Committee go further than they do in para 5.30 and recommend that professionals other than auditors commit themselves to the defence of business ethics? I submit Annex 2.

I should like to apologise for putting these points to you now, but they do arise from recent events rather than from the untimely reform of indolence....

Yours sincerely

Take-overs - their inter-relationship with "Going Concern"

Boards, when threatened with takeover, tend to perceive themselves separated from their shareholders, avoid a dialogue with them but make a recommendation after, at most, consulting with larger shareholders. No fetter is proposed on a Board's freedom to reject an offer - it will not survive if it gets that really wrong.

But embattled Boards would be better placed if they were obliged to consult with their shareholders and to take a vote at an early stage both on the offer and on whether shareholders wish to suspend "going concern" as the Company's prime business objective. Shareholders who subsequently change their minds can always sell into the market and Boards can then see from post-meeting volumes what is going on amongst shareholders.

Still using the Lloyds/Midland example, cessation of business, which is what recommending a Lloyds's bid would have caused, was not, I suggest, within the Midland Board's established remit if they could see their way to continue to conduct the business as a going concern. This is implicit, not explicit, but surely explicit is how it should be.

The lead and lag of the unmatched cycles both of inflation and of the growth of a particular businesses in some years can see assets growing in value quite beyond the level where nett profits show a reasonable return. This is the problem at a lower level of business stature. Nothing led more to the loss of UK manufacturing capacity than inflation and its exploitation by asset stripping.

One can say that forecasting can avoid this problem of volatile assets. But the Companies with 100-2000 employees are often producing a wonderful product and have not yet reached the first base from which they can take a broader view of their affairs. They need access to the stock market's capital, but they can not plan for more than 2 years out. They are real "going concerns" but can not afford yet to consolidate their growth. This is the problem at the lowest level.

All these share the problem of some shareholders perceiving their investment not as an investment in the business, but just a paper way of making money. Wider share ownership has this risk. If it is not guarded against on sound ethical principles, there is anger and recrimination. This comes from the the small shareholder and from the employee without a job. They blame "the City". Asset stripping as Lloyds Bank would have stripped Midland, will always be lurking. **Fund Managers can not resist short termism from their desks but are often reluctant to voice their views in general meeting.** There was a real mood at Midland's AGM for continuation of Midland and even though staff were present, the example is most useful.

To get started on this problem, could the Committee state as part of their Code that Articles of Association of quoted UK public companies, except "Investment Companies", include an Article <u>"..that the directors, if they receive a bid for the voting shares or stock of the Company and are agreed that they wish to negotiate on and do not wish to reject that bid, must convene an Extraordinary General Meeting of that class of share- or stockholders and for which meeting a minimum of 7 days' prior notice must be given. They must make no recommendation on the bid nor disclose their position. If the directors believe the bid would cause the cessation of the Company's business they must put a resolution to the EGM that there should be no suspension of the Article that the business be conducted as a "going concern". A resolution must in any event be put to the EGM that Shareholders reject the current bid. The Board may give to the meeting a verbal recommendation which modifies the rejection of the bid."</u> This resolution would ensure a vote, would expose the mood of the meeting and could have the effect, to the point if the Chairman held discretionary proxies and wished to sway it, of the resolution being rejected and the bid being accepted by the EGM. The predator would be present but the Board could thus play its opening and most difficult hand in concert with its shareholders instead of alone.

IJM
11th July 1992

Fraud

All the current doubts about regulation leaves London in a very shadowy or even shady light. The SIB, so that it can identify non-compliance, has set up a procedure where it and its SROs have straight lines of fire.

Fraudsters see these lines of fire and avoid them. They will only be caught in cross-fire.

The simplest approach to the discouragement and discovery of fraud is to involve all professionals undertaking work which attracts the compliance requirements of the FSA.

**All professional bodies governing the provision of services under the FSA could be given the opportunity to become SRO's on the condition that their Funds and Charters are at risk, answerable to the SIB. <u>When any registered professional is confronted with reasonable cause (not with evidence) to suspect that a fraud may be becoming evident to him/her during work for a client, that professional (not the professional's firm) must report this suspicion to a compliance supervisor in an SRO to which s/he is answerable. Thereafter, monthly reports must be submitted by the firm to the SRO using a case number only to reduce the risk of information leakage. The firm would be responsible to the SRO for making a closing report and will be at risk until doing so. If an alleged fraud is discovered and any firm has been engaged upon work that has brought it into contact with evidence of the alleged fraud, and has failed to suspect any wrong-doing, the SIB would be notified by the SFO or Fraud Squad or other Force, for inquiry into the firm's work by the Profession's SRO. The SIB would demand a case report and have sanctions after trial such as putting an announcement naming the firm in the London/Edinburgh/Belfast Gazette.</u>
These latter provisions would heighten the willingness of firms to give the early warning report and also strengthen the hand of the professional body in seeing that general standards of its profession have been met. Some professional bodies would say "pass" to being an SRO on these terms, so that a residual umbrella SRO would need to be created.**

The SIB perhaps at present wants to simplify the SRO structure. We have to ask whether that will help catch more fraudsters. I submit that the answer is "no".

Now is the time for this because it will concentrate the minds, before some professional bodies register as SROs, as to which of them will risk their being sufficient unto the day. <u>Whilst this is an FSA matter, it is simple, it will produce screams, and it will work.</u>

Where does it leave the present SRO's? Probably best as Agencies for sectors who still ordain compliance routines, and still require and inspect for adherence to compliance procedures. But their interest in **persons** working for registered organisations would all but cease. The hot focus would change to the professional discipline enforcement.

Perhaps there is a risk that those in Audit work may object to this proposal, but their insurers and thus with experience the Audit community itself, are likely to take a very supportive view.

This would considerably extend the recommendations within paras 5.28 and 5.30, but the need for rather less benign regulation is surely pressing hard?

IJM
11th July 1992