Sir Adrian Copy for retention.

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COMMITTEE
ON
THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

PO Box 433
Moorgate Place
London EC2P 2BJ
Tel: 071-628 7060 ext 2565
Fax: 071-628 1874

9 October 1991

David Clutterbuck Esq
The ITEM Group plc
Burnham House
High Street,
BURNHAM
Buckinghamshare SL1 7JZ

Dear Mr Clutterbuck,

I am sorry that I have taken so long to acknowledge your letter of 28 August and enclosures. I have read them with interest and drawn them to Sir Adrian Cadbury's attention.

We shall be addressing the role and responsibilities of independent non-executive directors, and the form and content of annual reports. Your papers are a most helpful contribution on these subjects and I am grateful to you for submitting them.

So far as training is concerned, you may be interested to know that a committee under the chairmanship of Mr Hugh Parker and meeting under the auspices of the Institute of Directors has been developing a training package for new directors. I understand that the project is now at an advanced stage.

Yours sincerely,

Nigel Peace

Nigel Peace
Secretary

Why ethics matter

The cost of neglecting the highest standards of ethical behaviour can be substantial.

When business historians look back at 1990 they will probably regard it as the year of executives in the dock. On both sides of the Atlantic senior executives of major companies have been accused and sometimes convicted of serious crime, leading a host of commentators to wonder how other managers can be expected to behave ethically if this is the example that business leaders give.

At the same time, an increasing number of chief executives have come under pressure to resign because public opinion demands that they should not only behave honestly, but be perceived to do so. The costs of neglecting a positive and viable insistence on the highest standards of ethical behaviour are high, both to the individual and his company.

For some of those executives who have broken the law there is clear evidence of personal gain as a motive. But only for some. Ernest Saunders, for example, apparently believed himself to be acting in the interests of his company rather than of himself. Often personal financial gain resulting from illegal activities is at best indirect. Several studies indicate that such behaviour is far from uncommon and indeed that the majority of executive crimes may be of this kind.

What appears to happen is that the company becomes such a dominant part of the executive's life that his or her sense of moral values becomes distorted. If it is right for the company, it must be right for the community. Few of these executives act in isolation. They usually gather round them a coterie of equally committed managers who reinforce each other's values. People who would not approve, or who might blow the whistle, are excluded from the club - where the action is - making

What Boards can do to ensure companies behave ethically

those within it feel even more close-knit. The club then develops a momentum of its own, becoming difficult or even impossible to control.

The strange thing about these executives is that they are otherwise remarkably law-abiding citizens and often pillars of the local community. However, they have built up a wall between the morality that applies in their personal life and that which applies in business.

So what can a board of directors do to ensure that a company does behave ethically? There is no simple answer, nor is it likely that any company can totally eradicate the possibility of wrong-doing. But the board does have a duty to take what practical steps it can, and these should normally include at least the following:

Publishing a code of ethics

Some kind of touchstone or guidance is essential to help managers decide when - in the view of the company - an action is right or wrong. Only the board can make this decision, although it may delegate some of the groundwork to a sub-committee.

About 70% of Britain's top 1000 companies have some form of company statement that they use for setting broad standards of behaviour. However, establishing a statement of values - what the company stands for and how it will treat each of its stakeholders - appears in many cases to be easier than creating a code of ethics. Many companies avoid issuing codes of ethics for fear of suggesting to the outside world that they have a problem in this area. But the reality is that every company

Employees must be made aware of the code

does, even though it is not readily apparent.

How many boards of directors, for example, would relish the embarrassment of Cyril Gay, the chairman of Eurocopy, some of whose salesmen have been accused of deliberately misleading customers into signing unfavourable agreements? Although Gay was reported recently by The Sunday Times as saying that all justified complaints would "be resolved at the group's expense to the customer's satisfaction", the damage to the company's reputation had already been done.

Contrast this with the enhanced reputation of Johnson & Johnson, the US multinational. When an extortionist poisoned a batch of pain killers in 1982, instead of waiting for instructions many staff went out immediately to warn shopkeepers and removed the product themselves. Because company policy had already addressed the problem, people knew what was expected of them.

Among firms with a strong belief in promoting a formal code of ethics is Cadbury Schweppes. Sir Adrian Cadbury explains that company policy towards gifts obliges employees to consider two rules of thumb: "Is the payment on the face of the invoice? Would it embarrass the recipient to have the gift mentioned in the company newspaper?" The first ensures that all payments, however unusual, are recorded and go through the books. The second is aimed at distinguishing bribes from gifts, a definition which depends on the size of the gift and the influence it is likely to have on the recipient.

Constant vigilance is necessary to police the code

Performance monitoring

Monitoring the performance of executives and managers against the ethics code is essential. An ethics code is only of value to the extent that people take notice of it. The company has to take active steps to police the policy.

Companies on both sides of the Atlantic use a variety of means to achieve this. Some, such as Perkin Elmer, require all managers to confirm that they have not deviated from the ethical guidelines; the company conducts sample audits to check that these statements are true. Others - about one in four of Britain's top companies - make ethical monitoring a specific responsibility of non-executive directors; in some cases, this means setting up an ethical sub-committee of the board. Among the danger signs to look for are the establishment of secretive cabals where a small group of key individuals withholds information that would normally be more widely available. (This appears to have been the case at Guinness, for example.)

A few companies have also given individual directors the responsibility to intervene to maintain ethical standards. For example, in the late 1970s, Gillette appointed a Vice President, Product Integrity. When managers in one division proposed to launch a new shaving cream aerosol, knowing that it would only deliver three quarters of its contents, he blocked the product. The managers argued that the customers would never know but the VP, supported by the board, insisted that the launch was delayed for many expensive months while a new propellent was developed.

The executive team must be seen to be taking ethical issues seriously

Emphasizing ethical behaviour

An increasing number of business schools now have ethics on the curriculum - including Harvard, influenced by a large gift that specified all students must attend business ethics classes. But the primary responsibility for ethics education has to lie with companies themselves.

Even small companies can institute ethics training. For example, Coils and Cables, a 44-employee company, backs up its ethical code with lunchtime role-playing sessions. The managing director leads these sessions every two months, inviting employees to discuss issues such as "Should a manager accept an all-expenses paid weekend at the World Cup from a supplier?"

Ethics training should also be reinforced by the example set by top management. If the executive team is clearly seen to be taking ethical issues seriously, so will other managers.

Creating a framework for registering concern

Auditing and training will still not necessarily bring all wrong-doing to light, particularly if senior managers are involved. So companies need mechanisms which encourage people who feel disquiet about activities to register their concern.

In some companies, a non-executive director acts as an informal ombudsman on such issues; in others, such as the John Lewis Partnership, there are frequent discussion groups where employees are asked to speak up on ethical issues. John Lewis also has

Employees should feel confident when expressing concern

an anonymous letters page in its staff magazine to which people can write if they feel something is immoral, illegal or unfair.

Perhaps the extreme example of this kind of openness is the US equivalent of the Atomic Energy Authority which has an annual staff competition for the best dissenting essay. The programme, which is highly regarded internally, is a recognition of the fact that it is better to have potential whistleblowers bring issues directly to the board, rather than to have them aired in the Press first.

In conclusion

Just how the board tackles each of these four steps is a matter for the individual company to decide. But the potential financial damage from ethical failures makes it essential that every company does deal firmly with these issues. It is one of the few points on which everyone would probably agree.

STEPHENSON COBBOLD LIMITED 84 Palace Court, London W2 4JE Telephone (071) 727 5335/(071) 243 1383 Facsimile (071) 221 3698

Shareholder communications: the CEO's responsibility.

Keeping investors informed will demand an increasing amount of the Chief Executive's time in the 1990's.

Communicating with the proprietors of a business is just one part of a Chief Executive's role today. However, opinions differ in Britain's boardrooms as to how such responsibility should be handled. "When I was at ICI I used to read every letter from a shareholder and make sure I answered it personally, if needs be", says Sir John Harvey-Jones. At the other end of the spectrum, to paraphrase another controversial CEO, "My involvement in investor relations is a waste of time; people buy and hold shares simply on the trading and financial performance of a company."

Why bother?

A recent study conducted for Stephenson Cobbold provides insight into this lack of consensus; it also demonstrates the perceived importance and benefits of maintaining good shareholder relations, and especially of programmes incorporating the personal involvement of the Chief Executive. The main benefits are stronger and more stable equity values which make it easier and cheaper to finance further investment; and shareholder goodwill, which can play an invaluable role in protecting a company in hard times and in defence against any predators. "The Chief Executive who spends his time communicating with shareholders. . . finds they have the confidence to support him if times get tough," says David Cassidy, Managing Director of Widney plc.

Michael Meyer, Chairman of Emess, concurs, "If we had a hostile bid tomorrow I don't think I'd have to see my top 20 investors, who hold more than

The personal involvement of the Chief Executive in the dialogue with shareholders can be invaluable.

50% of the equity, because we have built up their loyalty. When we needed urgent proxies a couple of years ago, for example, we started asking on Thursday and had them all in by Monday."

An essential, if difficult, relationship

However, the relationship between Chief Executives and shareholders, particularly the large institutions, has never been especially easy. Although they have a good many objectives in common - both in theory want capital appreciation and growth in earnings per share and dividends - they also have major differences. For example, says Meyer, "Investors often don't understand the value of a business: businesses are not something you can switch into or out of like shares. So there's a fundamental disparity of views."

Sir Simon Hornby, Chairman of WH Smith, highlights a major area of friction: whilst institutional shareholders expect top management of companies to behave properly towards them, the same institutions do not always recognise their own responsibilities. "They should be investing in a company because they believe in it, rather than to make a quick buck," he explains. "I get angry when I read that 'WH Smith's view is longer term than the City wants'."

The essence of effective shareholder relations appears to be understanding and responding to their justifiable expectations. But what do they expect? According to the Chief Executives interviewed in the study, shareholders require:

Developing a relationship between shareholders and the management team can pay dividends.

- That the business will be run well (profitably and ethically).
- That share values will be enhanced by dividend increases and market confidence leading to capital appreciation - this confidence is often a reflection of the perceived capability and track record of the CEO and his team.
- That their needs and views will be listened to and considered.

"His shareholders love him - because he talks to them"

All of the Chief Executives interviewed stated that they spent a considerable amount of their time communicating with shareholders - concentrated especially, as might be expected, around the major reporting periods. The more frequently they reported, the more evenly spread across the year the workload tended to be. Although some had delegated routine work to investor relations departments, they found there was no real substitute for developing personal relationships between the CEO and the shareholders. "Tiny Rowland may not be popular with the Establishment," observes one Chairman, "but his shareholders love him - because he talks to them."

Of the many media available for apprising investors, three remain the most popular: the annual report, the annual general meeting and lunches with institutional investors and analysts. Glossy annual reports are by and large a relatively ineffective means of keeping shareholders informed. However, when Thorn EMI sent investors and analysts copies of its annual employees report

The more information the better.

(which used simple language and provided much more information about what was going on in the various divisions) it discovered that many found this report more useful.

Getting the message across

Nonetheless, numerous CEOs are making strenuous efforts to ensure that their annual reports contain a wider range of information - both positive and negative - that will enable investors to gain a broad picture of the company, its activities and its business philosophy. BNFL, for example, carries a key section on health and safety activities; Marks & Spencer and RTZ have included additional publications about their community relations policies. LASMO's Chairman, Lord Rees, sends a selected list of investors - and any shareholder who so requests - a separate company profile along with the annual report. The profile goes into much greater detail about the circumstances of, and prospects for, each area of the company. BP has a similar policy with regard to press releases, sending them to a lengthy list of shareholders at the same time as to the Press. A growing number of companies, such as BET and BP, also produce road shows in a conscious effort to reach all shareholders. The time and cost of this kind of information dissemination is only worthwhile, however, if it is both credible and reassuring.

Methods used

Few of the CEOs perceive the AGM as a particularly strong vehicle for cementing shareholder relations unless the company has a large number of private

The personal involvement of the CEO in this communications process is an essential part of his role.

or employee shareholders. David Roper, a Director of Wassall plc, whose shares are mainly institutionally held, explains: "Very few institutional investors turn up for ours; we hope they feel well enough briefed already." Some US companies have resorted to video-conferencing so that investors in different countries can attend the AGM without excessive travel, but the idea has not met with much enthusiasm in the UK so far.

Marketing the company to the City

Several CEOs expressed resentment at the time they spent with analysts, often because of the analysts' apparently superficial understanding of the business. Says one Chairman: "None of these meetings ever gave me anything that helped me run the business better." However, others go to considerable trouble to arrange regular lunches for large investors and analysts, if necessary on a one to one basis where shareholders are concerned. BP, for example, ensures that these lunches are also attended by the heads of subsidiary businesses who can answer detailed questions.

Even small quoted companies find this kind of activity important. Sam Smith, Chairman of Bimec Industries, comments that after considerable effort he has persuaded fifteen brokers to follow the company. He invites brokers to bring institutional investors to lunches, explaining: "You have to take the initiative: small companies are not so well looked after since Big Bang."

How informative to be on these occasions can require a delicate balancing act.

"A surprise-free life is what shareholders want..."

As Sir Eric Pountain, Chairman of Tarmac, expresses it, the trick is "to promote the company whilst at the same time being honest on prospects and confidential on matters of commercial sensitivity." Adds Michael Meyer: "We aim to provide the institutional investors - who own 90% of our company - with their own private view of what's going on and whether they should be in the shares or not."

In conclusion

Sir John Harvey-Jones comments, "A surprise-free life is what shareholders want and it is up to the CEO to provide it." For this reason, BP ensures it produces briefing documents - which give both the good and the bad news - so investors are always aware of the context of business moves.

Effective shareholder communications - so that investors feel informed, consulted and considered, if not actively involved - is likely to demand an increasing amount of the Chief Executive's time in the 1990's, many may find that they are forced to re-examine their priorities to accommodate these demands but, whether it is seen as pleasure or pain, investor communications is a fundamental and growing part of the CEO's role.

As Michael Meyer emphasises:

"A public company is not owned by the managers; like a politician, if you forget your constituency you will be out of a job."

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Executive Search Consultants

STEPHENSON COBBOLD LIMITED 84 Palace Court, London W2 4JE Telephone (071) 727 5335/(071) 243 1383 Facsimile (071) 221 3698

I T E M

The ITEM Group plc
Burnham House
High Street
Burnham
Buckinghamshire SL1 7JZ
Telephone: (0628) 662517
Fax: (0628) 667155/604882

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28 August 1991

Nigel Peace
Secretary
Committee on Corporate Governance
PO Box 433
Moorgate Place
LONDON
EC2P 2BJ

Dear Mr Peace

Thank you for your letter of 13th June, for which apologies at the belated response.

I have enclosed a couple of occasional papers, which I have written on issues relating to Corporate Governance. One looks at the question of the CEO's responsibility for maintaining and developing the ethical climate of an organization. The other reports on some recent research we carried out into CEO's perceptions of their roles vis-a-vis shareholders. The latter found a remarkably low level of agreement among CEOs.

To pursue the ethics issue, I strongly believe that the board should contain an independent non-executive director, who has the credibility and breadth of understanding to act as corporate conscience. Employees with an ethical concern should be able to approach this director in confidence, in the knowledge that the issue will receive an independent evaluation. The director should have the authority, where necessary, to investigate matters on his own initiative. He or she should also sit on the audit committee. A practical output of his or her activities should be a social responsibility report within the Annual Report.

On a separate issue, having interviewed and taught thousands of executives over the past two decades, I am frequently struck by the poor level of competence many of them display in basic areas of executive management. While I would not support compulsory director training (it would simply be too unwieldy and would not be practical for many small businesses) I do perceive the need for measures to promote basic director competences.

Practical steps might be to:

* encourage the insurance industry to weight executive liability policies in favour of those who have a recognised diploma in company directorship

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Directors: David Clutterbuck, Michael Long
Keith Carby, Pauline Clutterbuck
Natalie Lynch, Eileen Scholes
Reg. in England 1971758 Reg. Office as above

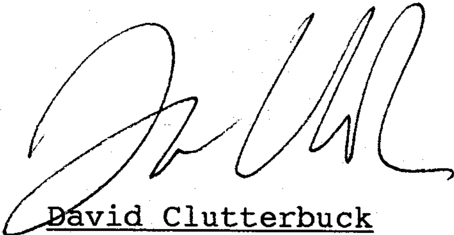
28 August 1991
Nigel Peace

* establish more firmly the differences in capability knowledge and function between directors and managers, with a view to developing better materials for training and development

* encouraging the use of younger executives as NEDs on subsidiary company boards, as a means of developing directorial skills earlier in their careers.

I hope these comments are helpful, and would be happy to expand upon them if you wish.

Yours sincerely



David Clutterbuck

Chairman

Enc