Sir Adrian

I haven't seen the correspondence to which this letter refers, but it suddenly struck me that 'Peter' is Peter Stormonth-Darling & that the paper is the IFMA piece on 'communication of business plans and insider dealing'.

If so, could I have copies, pl? I would like to work up a paper for the December meeting on the role and responsibilities of shareholders, and the IFMA piece would appear relevant from the earlier draft which I have seen.

Nigel

4/11

CAD-03235

MERCURY ASSET MANAGEMENT

17th October 1991

Dear Adrian

Many thanks for your letter of 15th October and your comments on my paper.

I entirely agree with you that there may be a large number of companies which are not performing as well as they should be through having ineffective boards. This is indeed a difficult situation for institutional investors to sort out and they are, of course, more likely just to sell their shares. There is little incentive for one institutional investor to solicit the support of others and thereby tip them off as to his own negative sentiment. Moreover, others may well disagree. It is hard to know how one can set objective tests as to when a company or board is not performing properly.*

All best wishes for your Committee. We will look forward to seeing your interim report in due course.

* other than the price of the shares!

Yours sincerely

Peter.

Sir Adrian Cadbury,
Committee on The Financial Aspects
of Corporate Governance,
P.O. Box 433,
Moorgate Place,
London EC2P 2BJ.

PSD/PC

replied 15/10/91

MERCURY ASSET MANAGEMENT

10th October 1991

Dear Adrian,

I enclose a paper which we have put together on various aspects of corporate governance. It is intended for internal purposes and for circulation to those of our pension fund clients who have expressed an interest in our views on the subject. At present I am only sending copies outside our office to you, to Brian Corby and to Charles Nunneley, in his capacity as Chairman of the Institutional Fund Managers' Association. While therefore I would be grateful if you would treat it as confidential, I thought you might like to have one fund manager's views.

All best wishes for the continuing work of your Committee.

Yours sincerely

Peter

Peter Stormonth Darling

Sir Adrian Cadbury,
Chairman,
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Corporate Governance
and the Role of Institutional Investors

A committee with representatives from government, business and finance under the chairmanship of Sir Adrian Cadbury will report early next year on the system of "corporate governance" in the U.K. The manner in which companies are governed has come under close scrutiny in the past year or so in the wake of some spectacular and surprising corporate failures as well as several high profile resignations of chief executives where it is known or widely believed that bankers and institutional investors were instrumental behind the scenes. The Cadbury committee is expected to produce a code of practice the aim of which will be to raise standards of corporate behaviour with the object of improving the competitive position of U.K. companies to the benefit of their shareholders and the national economy.

Corporate governance may be defined as the process by which managements of public companies are made accountable to their shareholders. In law, the board of directors governs a company in the interests of all its shareholders. The heart of the matter is to determine the responsibility for selecting and influencing boards and then to achieve the correct balance between boards, management and shareholders.

In this paper we set out Mercury Asset Management's views on three key aspects:

- How can corporate governance in the U.K. be improved?

- Who is responsible for ensuring good corporate governance?

- Will better corporate governance result in improved performance of the U.K. economy?

How can corporate governance in the U.K. be improved?

There are four main avenues for achieving better corporate governance: stronger boards; stricter accounting standards; better communications between management and shareholders; and finally "last resort" solutions such as intervention with a view to effecting management change, or ultimately, when all other steps have failed, take-over.

While the board as a whole is responsible to shareholders for the conduct of a company, it is the non-executive members who are the ultimate guardians of the shareholders' interests. Although in this country we are some way behind the United States where non-executives usually constitute a majority on public company boards, it is now widely accepted in the U.K. that the boards of public companies should include a healthy number of non-executive directors. It seems unlikely however that the U.K. will move to the German system of supervisory boards composed wholly of non-executive directors, even though this system may have its merits.

The responsibilities of non-executive directors as well as their remuneration should be more clearly defined and this is likely to be an area on which the Cadbury Committee will focus. Indeed, Sir Adrian Cadbury has recently argued that non-executive directors should be renamed independent directors to emphasise their objectivity. The main roles of non-executive directors should be to appraise management's performance against a defined business strategy, to ensure that succession is well planned and where necessary to make management changes. They should also from time to time challenge management's strategy, but it is not their function to second-guess them in their execution of day-to-day management.

While non-executives with a wide variety of backgrounds can be useful members of a board, executive directors of another public company who can bring to bear their current experience are

ideally qualified. This in turn means that public companies should in selected instances be prepared to allow their executives to sit as non-executives on other boards, in the process broadening their experience. As they have the security of an executive position elsewhere, non-executives with this background are more likely to take a strong stand against an autocratic chief executive than others who may be more reluctant to lose their non-executive position. There may be other cases where a retired person with more time and possibly experience to devote to a non-executive position may be appropriate. Investment managers prefer not to join boards themselves since this could lead to an inability to buy or sell shares for their clients during certain periods.

The danger in reality is that non-executive directors, who have probably been chosen by management in the first place, may become beholden to management and hesitant to challenge it. In any event, the ability of non-executive directors to confront a strongly entrenched management should not be over-estimated particularly given the constraints on time and availability often faced by non-executive directors who have responsibilities elsewhere.

Another of the functions of non-executive directors should be to oversee the remuneration of the chief executive and the executive members of the board, usually through a remuneration committee. There has been unfavourable publicity in recent months over increases in senior executives' remuneration at times of declining profits. While many of these instances may be explained by a lag in the recording of incentive payments relating to earlier more profitable years, it is demoralising for middle management and depressing for shareholders where it has happened. Incentives will ultimately only be acceptable to shareholders if they are tied to the performance of the share price or earnings per share over a reasonable period of time, ideally not less than four or five years. Stock options are to be encouraged inasmuch as they are long-term in nature and give

management the same interest as the shareholder in seeing a higher share price. While there have undoubtedly been abuses in remuneration practice, it must be recognised that there is a competitive market place for senior executives, and that a board must do everything it reasonably can to retain the people who are critical to a company's future. It must be for the non-executives, taking advice where appropriate from outside consultants specialising in executive remuneration, to decide what is right to achieve this.

A related feature of company remuneration arrangements which needs to be addressed is that of directors' service contracts. These have become an increasing feature in recent years, making the removal of directors from the board of a company more difficult. We believe first, that the terms of directors' service contracts should be overseen by the non-executive directors and secondly, any service contracts of longer than one year should be approved by shareholders at the annual general meeting. All service contracts should be revealed in the annual report.

There is increasing support for separation of the roles of chairman and chief executive. However, a survey carried out a year ago of the 100 leading U.K. companies showed that 18 had a non-executive chairman, 42 had a full-time chairman as well as a full-time chief executive, and 40 had one person fulfilling both roles. There were examples of success and failure in each category but separation is, we believe, generally desirable. There is, however, room for other board structures. Unilever, for example has a special committee of three which acts as a 'plural chief executive' thus giving continuity at the most senior level.

The second route to better corporate governance is through stricter accounting standards. Current studies by the Accounting Standards Board are aimed at increasing disclosure in general and at reducing flexibility in the accounting treatment of such

matters as acquisitions. Under current procedures, it is possible to boost profits through skilful use of provisioning and below the line items where a high degree of discretion is available to companies. More exacting accounting standards are to be welcomed as a means of promoting comparability between companies and thereby the efficiency of capital markets. The subjectivity involved in preparing financial information indicates however that the main thrust of accounting reform should be placed on greater disclosure.

Although it is the shareholders who appoint the auditors, the method of appointment makes the process seem as if it is handled by the board. Furthermore, there is a tendency for auditors to be more influenced by the board than the shareholders might wish or expect. Shareholders similarly see auditors as remote and not as their agents. Auditors should always bear in mind that their responsibility is to the shareholders and some method of improving the medium through which the relationship between the two can be made more direct would be welcome.

To act as an interface between auditors and the board there should be an audit committee of the board consisting of a majority of non-executives. This committee should assist the board in discharging its responsibilities in regard to financial reporting and accounting policies. It needs to have unlimited access to the finance director who should not himself be a member, but it should avoid encroaching on areas which are the day-to-day responsibility of the finance director.

The next avenue for improvement of corporate governance is communication between management and shareholders. The situation in this regard has improved markedly in recent years as chairmen and chief executives, as well as finance directors, have taken the trouble to meet institutional shareholders regularly to explain their activities and objectives. This is a well travelled road which is no longer considered burdensome by most managements. Institutional investors, for their part, owe it not

only to their clients but also to the companies in which they invest or are considering investing to improve their knowledge and understanding of the businesses and strategies of those companies. Institutional investors should encourage long-term investment in new facilities, technology, research and training, and discourage any attempt to boost short-term profits artificially.

Institutional investors should generally aim to avoid being made insiders by managements confiding price-sensitive information since this will preclude them, for however short a period, from either buying or selling shares for their clients. If managements want to influence expectations as to the progress of their business or to disabuse a general impression which may be either too optimistic or too pessimistic, their responsibility is to make a public announcement rather than to inform one or more institutional investors or brokers' analysts. Small shareholders would have a legitimate grievance if they felt that institutional investors, by virtue of their size, were being given information on a preferential basis.

Where a company has consistently failed to achieve an adequate return on its capital and assets over a period of time and management has been unable to provide a convincing explanation, last resort solutions may be required. An institutional shareholder, probably working in conjunction with the company's merchant banker, may take the lead in putting pressure on the board for a change in top management. However, it is often the case that individual institutions do not have large enough stakes in companies to gain sufficient support on the case for intervention before it is too late. Moreover, while there are some occasions where intervention is the appropriate course of action for institutional investors, it should be understood that their skills are in investment management, and not in the removal of chief executives or in the identification of their replacements; in the first instance it should be for boards, in particular the non-executive directors, to carry out these functions.

Intervention of this kind is unusual and in many cases of corporate underperformance it may not be feasible either because the board is too weak or indecisive to take the necessary action, or because support from other shareholders is not forthcoming. In such cases it is perfectly proper for institutional investors, acting in the interests of their clients, either to sell their shares or to support a take-over.

The take-over is an essential part of the U.K.'s free market system, a useful way of effecting change and a means for successful companies to achieve world class and size. While there has been criticism in recent years of the relative ease of take-overs it should be noted that it is generally the underperforming companies which have been taken over. Well managed and successful companies have seldom been bid for and, where they have, they have usually been able to convince their shareholders of the long-term merits of their remaining independent. While government can make take-overs more difficult if it so chooses, it is to be hoped that the important spur to managements which the possibility of take-over provides will not be blunted through well intentioned but misguided attempts to protect underperforming managements. The duty of institutional investors in a take-over is to listen carefully to both sides, and to decide in their clients' best interest. When they accept a bid they are engaging in the ultimate act of corporate governance by agreeing to a change in ownership and almost inevitably thereby in management too.

Who has the responsibility for ensuring good corporate governance?

A century ago most publicly quoted companies had a controlling shareholder, sometimes an individual proprietor or family and sometimes another company, and there are still a number of examples of this type of control today. In Germany, the banks, having had to acquire ownership of many of their corporate customers in the 1930's and 1940's, still control many

of the major companies, while in Japan companies often belong to industrial groupings. In these instances, it is obvious that the controlling shareholder in his own interest will want to take a close interest in the governance of the company and the membership of its board. In the U.K. the ownership of shares has developed differently. Whereas private individuals owned 54% of all quoted shares in 1963, it is now the institutional investors, the largest element of whom are pension funds, who collectively own approximately two-thirds of all quoted shares, while private individuals hold only a little over 20%.

There has been a growing recognition that institutional investors ought to fill the void and assume the responsibility for ensuring good corporate governance. As a consequence of the size of their holdings, pressure on institutional investors to do so has come from government and bodies such as the Association of British Insurers, the National Association of Pension Funds and the Institutional Shareholders Committee. Since institutions are generally unable to sell their holdings collectively, although they can of course sell to each other, it is logical for them to respond positively to the challenge and there have been a number of recent occasions where they have asserted their rights on behalf of their clients' shareholdings.

Earlier this year the Association of British Insurers circulated a discussion paper on the responsibilities of institutional shareholders setting out the following principles of good practice.

1. 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.

2. Institutional investors will not wish to receive price sensitive information as a result of such dialogue but will accept it on an exceptional basis as the price of a long-term relationship, although this may require that they suspend their ability to deal in the shares.

3. Institutional investors are opposed to the creation of equity shares which do not carry full voting rights.

4. Institutional investors should support Boards by a positive use of voting rights, unless they have good (and stated) reasons for doing otherwise.

5. Institutional investors should take a positive interest in the composition of Boards of Directors, with particular reference to:

   5.1 Concentrations of decision-making power not formally constrained by checks and balances appropriate to the particular company.

   5.2 The appointment of a core of non-executives of appropriate calibre, experience and independence.

6. Institutional investors should support the appointment of Remuneration and Audit Committees.

7. Institutional investors encourage disclosure of the relevant details of directors' contracts.

8. In take-over situations, institutional investors will consider all offers on their merits and not commit themselves to a particular course of action until they have reviewed the best and most up-to-date information available.

9. In all investment decision-making institutional investors have a fiduciary responsibility to those on whose behalf they are investing, which must override other considerations.

These principles are mostly good common sense. However, for pension fund managers such as Mercury Asset Management it may be inappropriate and impracticable to exercise voting rights on all occasions. In our regular meetings with the management of companies in which we invest we are often able to influence management policy in a more effective manner than would be the case through routine voting on all board resolutions. Although such influence, by its nature, is rarely publicised, it is our policy to raise issues of concern to us and our clients at these meetings and we believe that differences over management policy are more likely to be resolved in private discussions than in public debate. There is also the risk that voting by institutions as a matter of routine might degenerate into a passive form of blanket support for boards. In particular, voting against a resolution, or even abstaining, could be taken as a signal of our intention to sell a share which could disadvantage our clients by depressing the share price.

Will better corporate governance result in improved performance of the U.K. economy?

During the debate on short-termism the belief has been expressed in some quarters that the performance of the U.K. economy would somehow improve if only the City's investment managers would put aside their short-termist ways. To investment managers trying to identify companies with clear-cut long-term strategies and growth prospects in which they can invest their clients' money with confidence for the next decade, such attributions of influence, while flattering, seem unwarranted.

Now a new delusion is beginning to surface: if institutional investors would start behaving as owners of the businesses in which they invest with full responsibility for their governance rather than as mere investors who treat shares as bits of paper, all would be well with U.K. industry. To hold such a view is to place far too great an emphasis on what better corporate governance can achieve.

First, there has been a great improvement in corporate governance standards in the past decade and most of the larger U.K. companies, by definition those which play the greatest role in the economy, are well managed and already follow best practice. Secondly, the observance of good corporate governance will not bring with it better managers or engineers. There is even a danger that an undue concentration on codes of practice through an excess of committees and bureaucracy will stifle the very entrepreneurial qualities which are needed for innovation. Nor will it eliminate macro-economic barriers to growth and innovation in the U.K. such as the high cost of capital, both nominal and real, as well as those cultural and educational influences which have resulted in so many of the best minds in the country pursuing careers in the professions rather than in industry and commerce.

On the other hand, better governance practice, especially more regular communication, will help to make management more accountable to shareholders, and it should result in fewer failures and abuses by self-serving managements. It should also lead to a higher level of public confidence in the way companies are managed. It is not a panacea, but it is a step in the right direction.

Mercury Asset Management's Approach

Mercury Asset Management's first duty is to its clients. We support initiatives such as the Cadbury committee in its aims of improving corporate governance which in the main are unlikely to conflict with that duty. It is our policy to invest in companies which have good management and well developed and articulated long-term strategies: these are usually the ones which already follow best governance practice. In addition, we will continue, where appropriate, to seek to influence managements through our regular dialogues with them, and may from time to time be active behind the scenes in implementing change.

At the same time we recognise that there are a number of different structures within which good management can be carried out, and believe it will be important not to swamp management with rules and regulations which inhibit enterprise. It would be a pity if corporate governance were to become a corporate governess. It is our hope therefore that the Cadbury committee does not put forward a code of practice which is too inflexible, and that its principles are only subsequently enacted into company law if there is widespread acceptance of them by companies and institutional investors alike.

PSD/PC
October, 1991