



Lancaster University
MANAGEMENT SCHOOL

Lancaster University Management School
Working Paper
2000/024

Strategic Directions for Corporate Governance

M J Mumford

The Department of Accounting and Finance
Lancaster University Management School
Lancaster LA1 4YX
UK

©M J Mumford

All rights reserved. Short sections of text, not to exceed
two paragraphs, may be quoted without explicit permission,
provided that full acknowledgement is given.

The LUMS Working Papers series can be accessed at <http://www.lums.co.uk/publications>
LUMS home page: <http://www.lums.lancs.ac.uk/>

STRATEGIC DIRECTIONS FOR CORPORATE GOVERNANCE

**Proceedings of a Conference on Corporate Governance organised by
The International Centre for Research in Accounting
Lancaster University Management School**

Edited by Michael J. Mumford

PREFACE AND INTRODUCTION

The revision of company law within the United Kingdom used to proceed largely by way of a series of company law revision committees, sitting at intervals of about twenty years, taking evidence at public hearings and publishing these discussions before Parliament was invited to debate a new Bill. The last of these committees led to the Jenkins Report in 1962, since which time there have been major Companies Acts in 1980, 1981, 1985 and 1989 without accompanying surveys of law and practice. A major pressure for these Acts, of course, arose from Britain's membership of what was to become known as the European Union. Harmonisation of company law follows from the need to remove barriers to trade and business organisation amongst the twelve, and later fifteen, countries that comprise this economic entity.

There remain some clear differences between the patterns of business organisation that have grown up in different member countries of the European Union. Some countries have many more forms of corporate body than does the United Kingdom. The typical patterns of financing often differ too, with greater reliance on the European mainland on bank finance for long-term investment than is commonly the practice within the UK. The major lending banks within the UK tend to make what are formally short term loans, secured by floating charges over the assets rather than by specific charges over particular assets. While these loans (including variable amounts provided under overdraft facilities) are notionally repayable at short notice, they are often rolled over from one period to the next, so that they constitute a significant (but fluctuating) fraction of corporate finance.

It seems that the pattern of bank finance within the UK was heavily influenced by the collapse of the City of Glasgow Bank in 1878, which encouraged banks to take short-term rather than long-term stakes in their clients' businesses. The need for external sources of long-term finance was then filled by flotation on the several Stock Exchanges located in major cities around the country. This itself led to the increased transferability of share capital amongst both individual and corporate investors, together with the potential for the rights over cash flows, capital repayments and control over the investee company to become separated into different fractions as between the holders of shares.

The rise of large scale businesses within the UK may have been slower than it was in the United States (particularly in the economic boom which followed the end of the Civil War in 1865), but within Britain too there was scope for a "divorce between

ownership and control”, as documented so effectively in the US by Adolf Berle and Gardiner Means in 1932. This largely arose from the dispersion of shares amongst large numbers of shareholders who found it uneconomic to exercise control rights over the team of professional managers who assumed control day-to-day over the company. On the other hand, shareholdings became concentrated again in a relatively small number of hands within Britain earlier than they have within the US, with the resulting rise in economic power of the institutions – the pensions funds, insurance companies and others with large, diversified portfolios of shares in listed companies.

The significance for a business of external sources of capital clearly depends on how reliant that business is upon external finance, rather than the capital of its proprietors and manager. Retained profits constitute the major source of finance for most companies, and these do not depend for their generation upon shareholders as much as they do upon the effectiveness of the firm’s own activities, undertaken by its employees under the direction of the management. Thus the context of corporate governance was historically dependent, to a major degree, upon the power relationship between the firm and suppliers of the inputs that the firm required. The need for external sources of capital tended to depend upon how far the investment possibilities open to the company exceeded the extent to which it could generate funds from its own operations. Very profitable companies might generate large amounts of capital from their operations but still have attractive prospects for further investment that they could not exploit for lack of finance. For these companies (or, rather, their management), the attractions of a stock market listing would be strong enough to compensate for the extra cost and effort required to attract, and then reward, a body of external share investors who might have little knowledge of the company or of the industry in which it was engaged.

Moreover, the shareholders may have little commitment to long-term relations with the company in which their funds are invested from time to time. Their portfolios would typically be diversified, to avoid unnecessary risk; they would have little personal knowledge of the industrial technicalities of the companies in which they held shares; they could liquidate their interests (in listed companies, at any rate) rapidly at low cost, by selling in the market; and they could benefit from “free riding” on the monitoring activities of other, larger, shareholders who might participate in the governance of the company directly as well as influencing current market prices by the exercise of their skilled analyses. But, of course, these investors matter to a company that requires their funds. Moreover, shareholders might take great risks when they commit their funds for investment in assets of a highly specialised nature (which are irreversible in their usage), which might for their exploitation require complementary inputs (such as trained staff) whose supply lay outside the control of the shareholders, and might depend for their profitable usage upon the activities of a management team whose work was almost entirely invisible to the shareholders.

J.K.Galbraith has written (in *The New Industrial State*) of the three major eras of business up the late twentieth century. At first, land, and the ownership of land, was the major source of wealth; natural resources include the crops and creatures that could be raised upon the land, and adequate supplies of labour were assumed to be available. With the industrial revolution, from the eighteenth century, land ceased to be the scarcest resource, since its productivity was vastly increased by the application

of capital, in the form of irrigation and improved methods of farming. Capital became the major source of power (and status), with institutions reflecting this shift in power.

From the middle of the twentieth century, however, supplies of capital grew, mainly because of the increase in the rate of savings associated with government deficit financing together with the rise in pensions assets and retained profits. There was more than enough capital by the 1960s to meet all the profitable opportunities that were evidently available. Now the scarce constraint became the technical and managerial skills needed to generate new projects worth investing in. This is not to say that capital became unimportant, any more than land is unimportant in a world with a population increasing vastly more rapidly than foreseen by Malthus or Ricardo. However, technical ability, as a highly specialised resource with limited scope for new supplies, now matters to an extent that is unprecedented. The way that business is organised starts to matter, too, to an unprecedented degree. Productivity enhancement is by way of information flows as much as it is by improved machine tolerances and better materials.

The implication of this for corporate governance is that the recruitment of core staff, and ways to provide effective incentives to these people to innovate and operate in new ways, becomes correspondingly important. Adam Smith stressed the importance of the division of labour for wealth creation, but in his world the difference in productivity between skilled and unskilled pin-makers and weavers was relatively small. By contrast, today specialised technical skills present the potential for productivity enhancement several orders of magnitude greater than craft skills could offer. Against this background, the current debate on the reform of company law within the UK is set in the context of very rapid economic and technical change, globally as much as nationally, in which Britain has very strong links with the rest of Europe but also some distinctive strengths that are valuable and worth preserving within the context of wider European networks.

Publication of the consultation paper *Modern Company Law for a Competitive Economy: Developing the Framework* by the Company Law Review Steering Group was expected by mid-2000, so late in 1999 I approached the Association of Chartered Certified Accountants (the ACCA) in London to ask whether they would like to participate in a conference on corporate governance, to contribute to this process of review.

My plans at the outset were for a major international conference, bringing speakers from the US as well as other parts of Europe, to compare corporate governance models and evaluate them. I hoped to include lawyers and economists as well as accountants and experts in finance. In the event, the ACCA expressed a wish to sponsor the event by itself rather than jointly with others, and then suggested a closer focus on the prospects for strategic developments of corporate governance within the UK. This being agreed, I sought a team of speakers who could present informed views, but from a variety of perspectives.

The starting point, clearly, had to be someone who could show some of the major respects in which corporate governance models vary between different countries, and the ways in which these models contribute to the economy. Professor Colin Mayer, of

the SAID School of Business at Oxford University, was an obvious choice; indeed, I had recently heard him deliver just such a presentation to a conference in Sheffield in December 1999, organised by Professor Istemi Demirag for the British Accounting Association's Special Interest Group on Corporate Governance.

It is clear that, as they develop, companies frequently grow from origins as family firms or as spin-offs from larger groups until they need major financing from external sources. Conversely, some quoted companies revert from having their own listing on the Stock Exchange to private ownership, or de-merger, or merger with others. Professor Michael Wright, of the University of Nottingham, has for some years been an important writer on take-overs, mergers, and latterly management buyouts. Much of his work draws on transaction cost economics, a branch of economics that has grown strongly since 1970 and examines (amongst other things) the determinants of the boundaries between activities carried out within the firm and those that are carried out externally (for example, by way of "out-sourcing" components or services). Here was a suitable speaker to address the matter of the relations between companies and capital markets.

Corporate financial reporting arose, historically, from the need for companies to raise capital from external sources, particularly American companies which needed capital from Europe in the boom decades between 1870 and 1900. Hence the accountancy profession has a particular interest in the reporting context of listed companies, and in the governance relations in which this reporting function is located. It was important to find a senior accountant with an understanding of corporate governance, and Nigel Macdonald, of the London office of Ernst and Young, had been closely involved in some of the most important developments in Britain in this field. His experience with the Cadbury Committee, for example, suited him ideally to speak from this perspective.

However, the emphasis of the accountant tends to be upon the control of activities – with restraining rather than encouraging, setting limits rather than expanding boundaries. It was important, also, to reflect the need for innovation and wealth creation, as well as the need to control assets and distribute the wealth once it had been created. Corporate governance is also a matter of central concern to the Institute of Directors, and I asked them whether they would be willing to sponsor the conference, not by way of financial backing but by providing a speaker with expertise on the subject from the point of the view of directors who are subjected to scrutiny by monitors of various kinds. Lord Newton was well known as a member of the Conservative government up to 1997, as a party Whip and then as Social Security Secretary and Health Minister before joining the Cabinet as Chancellor of the Duchy of Lancaster and Minister for Industry. Since September 1998, he has been Professional Standards Director at the Institute of Directors, and he agreed to speak.

Shareholders are the owners of the company, but there have been suggestions in recent years, not least in the discussions emanating from the Department of Trade and Industry and the Company Law Review Steering Group, that there is scope for improvement in the way that shareholders interact with the company and its board of directors. There was attraction, then, in having as a speaker someone with close knowledge of stakeholder interests who could also address the broader issues of

corporate accountability. Sarah Wilson is the Managing Director of Manifest, which acts as an intermediary between investors, particularly the institutions, and companies in which they are invested. In particular, she was likely to have views about the functioning of company meetings and other information flows between companies and the outside world. In the event, Sarah presented a coherent and detailed challenge to investors and companies to widen their agendas and recognise the critical importance of environmental and social issues within their framework of corporate governance.

The sixth, and final, main speaker was Professor John Parkinson. It was essential, in my view, to have a lawyer, and moreover a lawyer who could bridge the divide between people with a relatively narrow professional view of the company, say as a vehicle for stock market investment, and those who saw the need for innovation and creativity as the major source of new wealth. Professor Parkinson was commended to me as a speaker by my Lancaster law colleague, Professor David Sugarman, and we were fortunate that John was willing and able to contribute to the conference, not only an engaging and stimulating speaker but also as a member of the Company Law Review Steering Group.

Since the International Centre for Research in Accounting was organising the academic content of the programme, it was appropriate for me to seek the aid of Professor Ken Peasnell, head of the Department of Accounting and Finance at the University of Lancaster, and Dr Steven Young, whose particular specialist expertise lies in corporate governance, to chair the morning and afternoon sessions. The ACCA provided not merely the finance for the out-of-pocket costs of the conference but also provided the venue, the booking services, and catering and management at 22 Lincoln's Inn Fields. The support of Roger Adams, Richard Martin, Elenid Davies and Jo Hemmings was particularly valuable to the success of the conference.

As for writing up the volume of proceedings, I have done this with the aid of Cheryl Scott, who transcribed the entire set of audio-tapes into a word-processed draft. It was then up to me to edit these drafts from the spoken work into the form of written text, without the repetitions and interjections that are typical of a spoken presentation but are irksome in a printed version. The presenters were invited to comment and correct my transcriptions of their addresses. They all did so. The text of the discussion sessions, however, has not been sent to the speakers for comment. The final results are offered to the Company Law Review Steering Group as a contribution to their consultation. Other copies have been requested by, or will be sent to, other people with an interest in corporate governance. While every effort has been made to avoid error or misrepresentation, neither the ACCA nor the International Centre for Research in Accounting nor myself as editor can accept responsibility for any remaining errors or for the uses to which the text may be put. Copyright remains with the individual presenters and with the International Centre for Research in Accounting at the University of Lancaster.

In terms of firm recommendations, this volume may offer plenty of material for thought, but not so much by way of clear and unequivocal guidance. My own recommendations would include measures to permit the company to recognise that much of its capital is in effect self-owned – that much of its capital comes from its

own earnings, and that most of the “reserves” represent the proceeds of its own endeavours. To show these all as part of shareholders’ funds is a fiction that to my mind has little merit. The argument that maximising shareholders’ wealth should be the single over-riding objective of the company seems to make little logical sense, since the shareholders play so markedly limited a role in the affairs of most companies (unless, as in many small companies, they are also the directors – in which they play a role in their capacity as directors). It was noted earlier that shareholders often have little sense of identification with the companies that they own, and little commitment.

The argument that the shareholders are the principal risk-bearers accords ill with the observable facts. Employees, managers, suppliers and customers are also likely to suffer alongside debt-holders when a company collapses, and some of these groups may enjoy less portfolio diversification than the average shareholder. When a company with limited liability fails, more often than not the creditors are obliged to take over the residual assets and bear much of the losses. (As the finance literature points out, with limited liability the shareholders own a “put option” on the assets, which they will exercise once the net assets are worth less than the value of the debts.)

It is often argued (as by Professor Parkinson in his presentation in this volume) that directors need to have a single, simple maximand – one over-riding group to whose interests the company should be primarily answerable. A similar case could be met just as simply by requiring that the main purpose of the directors is to maximise the value of the company itself. This accords with the way that the duty of directors is often phrased. Moreover, it is no more complex to interpret than a requirement to maximise the wealth of a heterogeneous, and constantly varying, population of shareholders, perhaps spread over many countries and engaged only loosely, if at all, with the long-term interests of the company. There is an old argument that companies in the UK cannot buy their own shares, lest they end up with no external ownership to appoint the directors. The weakness of this argument is that, quite commonly, the shareholders of small companies are also the directors; they appoint themselves, and there is little point in maintaining some fictional divide between their different roles. However, such a view is unorthodox at present.

The most central conclusion to come from this conference, I suggest, is the value of diversity. Flexibility of organisational structure and contractual power is likely to benefit the economy, even though – inevitably – this gives the greatest advantages to the ingenious and the quick-witted rather than the steadfast and, perhaps, the most loyal. I wish the Steering Group all success in its deliberations.

Michael J. Mumford

Lancaster, 25 July 2000

INTERNATIONAL CENTRE FOR RESEARCH IN ACCOUNTING
LANCASTER UNIVERSITY MANAGEMENT SCHOOL

STRATEGIC DIRECTIONS FOR CORPORATE GOVERNANCE

22 May 2000
ACCA, 29 Lincoln's Inn Fields, London, WC2A 3EE

CONTENTS

Introduction and Welcome	8
Professor Colin Mayer – Relationships with Growth and Innovation	9
Professor Mike Wright – Venture Capital, Exit to Market, and Conditions for Return	23
Nigel Macdonald – The Combined Code: What next?	41
Morning Discussion	50
Rt. Hon. Lord Newton – Corporate Governance Structures and Wealth Creation	60
Sarah Wilson – Reforming Shareholder Relations	68
Afternoon Discussion	76
Professor John Parkinson – Corporate Governance and Reforming Company Law	80
Final Discussion	90

INTERNATIONAL CENTRE FOR RESEARCH IN ACCOUNTING
LANCASTER UNIVERSITY MANAGEMENT SCHOOL

STRATEGIC DIRECTIONS FOR CORPORATE GOVERNANCE

22 May 2000

Introduction and Welcome

Michael Mumford: A word of introduction just to say, first of all, you are very welcome here today for this seminar on Strategic Directions for Corporate Governance. My name is Michael Mumford, and it has been my job to organise this particular conference on behalf of the International Centre for Research & Accounting at Lancaster University Management School. I have two colleagues with me: Professor Ken Peasnell chairing the session this morning, and Dr Steven Young chairing this afternoon.

We have a distinguished panel of speakers. We are delighted to see, first, Colin Mayer and Mike Wright. Then the speaker after coffee will be Nigel Macdonald from Ernst & Young. We hope that they will be able to stay with us for as much of the day as possible. The questions to the morning speakers are scheduled to come at the end of the morning, from 12.20 until lunch. Then after lunch we have Lord Newton, Tony Newton, from the Institute of Directors, Sarah Wilson from Manifest, and finally Professor John Parkinson from Bristol. The proceedings are being tape-recorded: we will transcribe the recording of the day's proceedings and I will then edit them for publication. An edited copy of the transcript will be sent by the end of July as a response to the consultative document from the Company Law Review Steering Group entitled 'Modern Company Law for a Competitive Economy: Developing the Framework'. This is part of the consultative process that has been going on for the last couple of years, which is intended to lead to new company law legislation within the next two years.

So the DTI will have a copy of the transcript of today's proceedings, but we've not asked the speakers to address their comments specifically to the discussion paper, even though clearly they will have quite a number of things to say which are relevant. When it comes to comments, discussions and questions, for the purpose of the record it would be very helpful if your comments are audible. So if you comment or ask a question would you make sure that you've got a microphone so that we capture what you have to say on the record. If you would introduce yourself by name and where you come from, that would also be very helpful in this connection.

You will see that the co-sponsors of today are The Institute of Directors and The British Accounting Association Special Interest Group in Corporate Governance. We are very grateful to them for their support and their help. We are most particularly grateful to the ACCA for facilitating the proceedings - for financially sponsoring the event and for providing us with these very pleasant surroundings in which to work. Some members of ACCA staff are here, including Richard Martin and Joanne Hemmings. So all I have to say is thank you very much indeed for your support, thank you very much to the speakers, to the Association, and to my colleagues who are going to be chairing the proceedings.

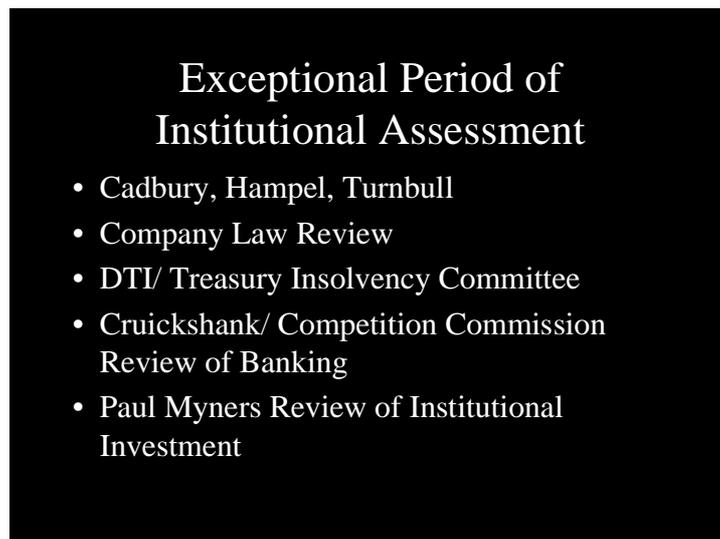
Ken Peasnell: Thank you, Michael. Our first speaker is going to be Colin Mayer from the Said School at Oxford, followed by Mike Wright from the University of Nottingham. Then there will be a break. Then Nigel Macdonald from Ernst & Young.

And then we're going to have a panel discussion. I don't know if the speakers want to take any questions as they go along - they only have 35 minutes each. So without more ado, I'll hand over to you, Colin.

Corporate Governance - Relationships with Growth & Innovation

Professor Colin Mayer, Said Business School, University of Oxford

Colin Mayer: Thank you very much. Firstly, thank you very much indeed for the invitation to speak here. I am delighted to be present and it looks like a very interesting conference and discussion.



Slide 1

The background to the discussion is that we're going through a period of exceptional critical analysis of British institutions. In large part, it was started by the Cadbury Committee and then picked up in various reviews of corporate governance, such as the Hampel and the Turnbull Committees, and, of course, as Michael was mentioning, we've got the Company Law Review in progress, well advanced. We had a committee reviewing insolvency in the UK - a DTI/Treasury committee on insolvency. We have recently had the Cruickshank Report on British banks, leading to referral of the banks to the Competition Commission. And, still more recently, we've had the government setting up Paul Myners' Review of Institutional Investment and that's not to mention the SMA and the reform of monetary policy which occurred recently. So there is a lot of analysis of British institutions.

Underlying Concerns

- Do British institutions enhance or detract from productivity, investment, innovation and performance?
- Have we appropriately balanced the interests of different parties: new economy v. old economy firms, creditors v. debtors, shareholders v. stakeholders, institutional v. individual investors?

Slide 2

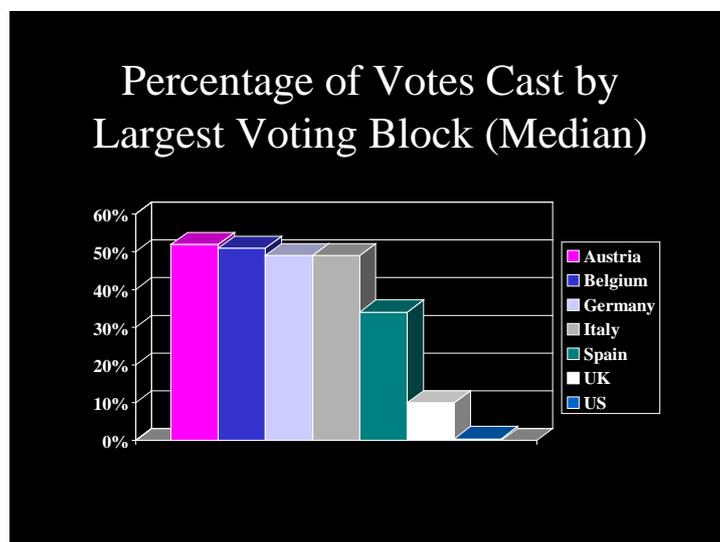
What has given rise to such self-analysis? Well I think there are two basic underlying issues or concerns. The first one is whether or not British institutions have enhanced or detracted from the performance of the British economy. By performance, what we have in mind is primarily productivity - but there are also concerns about levels of investment and in particular innovation, and the Paul Myners Committee is clearly focused on the question of the stimulation of start-up companies and venture capital activities. So there is a question about efficiency and performance that underlies many of those committees. But there is also a set of issues surrounding more distributional questions: the allocation of control and participation. So, for example, have we got the balance right between creditors' and debtors' rights? That is a fundamental issue that underlies the insolvency committee's investigation. Have we balanced the interests of the economy between new and old activities: are we still too focused on the old economy?

One of the issues that under-scored the Law Reform Committee Review is the balance between shareholders and stakeholders - an issue on which the reports to date probably still find more in favour of shareholders than stakeholders. There is a question about balancing the interests of institutional and individual investors, and whether or not institutional investors have served the interests of the financial system. The debate on corporate governance, I think, really illustrates all these concerns quite well.

Clearly, a basic question that corporate governance raises, if one thinks of it as really being concerned with performance accountability, is whether or not it leads to efficiency in terms of the management of corporations - whether or not incentive arrangements, such as shareholding arrangements, are giving rise to adequate managerial efficiency. But there is also obviously a set of debates particularly focused around participation: to what extent does one want to bring in wider stakeholder interests beyond those of pure shareholder concerns?

Now, what I want to suggest is that the debate about corporate governance is still too narrowly focused - that there is a set of issues that go beyond just the pure efficiency

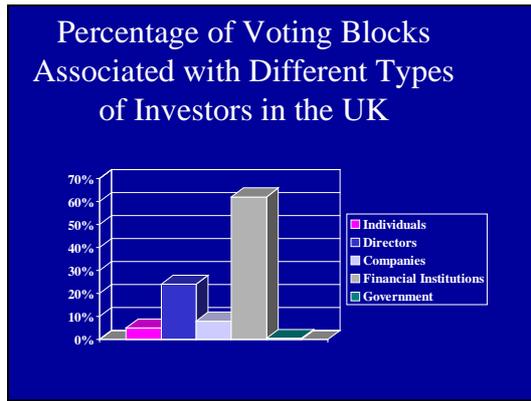
and distributional issues that I raised here which lie at the heart of governance questions. The starting point for raising that issue is the difference in the ownership – or, rather, the control - of corporations across different countries. It is only recently that one has been able to get extensive information about the ownership of companies because for the most part, as you know, in many European countries disclosure levels have been very limited. Over the past decade or so, the European Commission has been introducing what is termed a “large holdings” directive which requires large shareholders, or, in particular, holders of large blocks of voting rights in companies to disclose those voting blocks. There are various levels at which disclosure is required - for example, 10%, 20%, 33%, etc. - of the votes for the company. That is now a requirement for all listed companies in the EU, and it is just being extended to many transitional economies, so that actually rather good information about the ownership – or, rather, the control - of companies has just emerged. I say “control” because what it actually refers to is voting rights in companies rather than claims over cash flows.



Slide 3

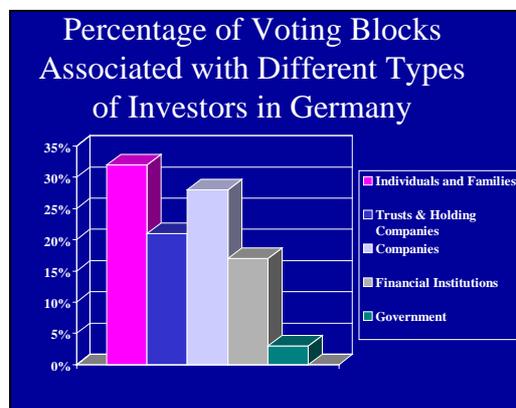
Now what this slide shows is the largest voting block that a single shareholder on average can cast in certain different EU countries - Austria, Belgium, Germany, Italy, Spain, UK – and in the US. It shows that in Austria and Belgium the single largest voting block can command a majority of the votes in a company, so a single holder or group of investors can cast a majority of votes in a company on average. In Germany and Italy it is just under 50%, and it is slightly lower in Spain. But the real contrast is between those countries, on the one hand, and the UK and the US on the other. In particular, in the UK the average single largest voting block is around 10%. In the US, it is so small that it is actually below the disclosure level of 5%. There are very different patterns not only of the size of holdings but also of the nature of those holdings across countries.

In the UK, we know shareholdings are dominated by financial institutions, although this next slide brings out the fact that there is a significant proportion of votes held by insiders, that is to say by directors (both non-executive and executive directors).



Slide 4

By contrast, in most continental European countries there are two dominant classes of investors – individuals (or, strictly speaking, families) and other companies holding shareholdings in each other.



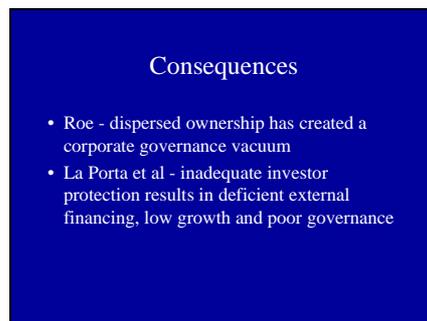
Slide 5

That is what this slide for Germany illustrates, and the picture for Austria looks very similar. Now, obviously, there is a very interesting question about the extent to which these patterns are changing, and to what extent we are observing convergence of systems across different countries. The most common view is that basically many of these patterns of ownership and control that we have observed in continental Europe are breaking down, and therefore we are getting convergence on an Anglo-American model. But one of the basic issues that these differences raise is what has contributed to such fundamental differences in the ownership and control of the companies.



Slide 6

There are two popular arguments in the literature for explaining these different patterns, both of which are primarily focused on regulation. The American lawyer Mark Roe put forward a viewpoint that has been very influential in the United States. He says that the dispersed ownership that was observed in the second half of the 20th century in the US was a consequence of a regulatory reaction to concentrations of control that existed in the United States in the first part of the 20th century. In particular, various bits of legislation that were introduced in the 1930s gave rise to serious costs and difficulties associated with having substantial share blocks in companies. So, according to Mark Roe, the US has actually been forced into a position of having dispersed ownership as a consequence of the regulatory interventions that were made during the first half of the 20th century. In contrast with that review is an analysis put forward by a number of Harvard and Chicago economists. Andre Shleifer, Robert Vishny and a number of their co-authors have argued that it is not the United States that is the outlier, but the rest of the world that is out of line. What is wrong with the rest of the world, they argue, is that most countries in the world have not got enough in the way of investor protection. So the existence of large blocks of shares is a reaction to inadequate investor protection that exists in most countries, including continental European countries. Thus, from their perspective, the observation of highly concentrated levels of ownership and control in most countries is a reflection of poor regulation, rather than dispersed ownership being a consequence of excessive regulation in the US.



Consequences

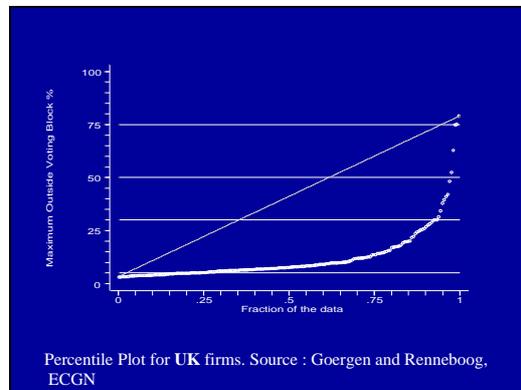
- Roe - dispersed ownership has created a corporate governance vacuum
- La Porta et al - inadequate investor protection results in deficient external financing, low growth and poor governance

Slide 7

Now, the implications of these two theories is that, according to Mark Roe, the problem is a US problem of dispersed ownership creating a corporate governance vacuum in which there are no significant shareholders who have incentives to engage in active corporate governance. According to the La Porta, Vishny, Shleifer *et al* story, the problem exists in most other countries, where there is inadequate investment protection resulting in deficient participation by small investors and deficient external financing, giving rise to low growth and poor governance. These two views then come to diametrically opposed conclusions about the policy implications of regulation and the desirability of different structures of ownership and control.

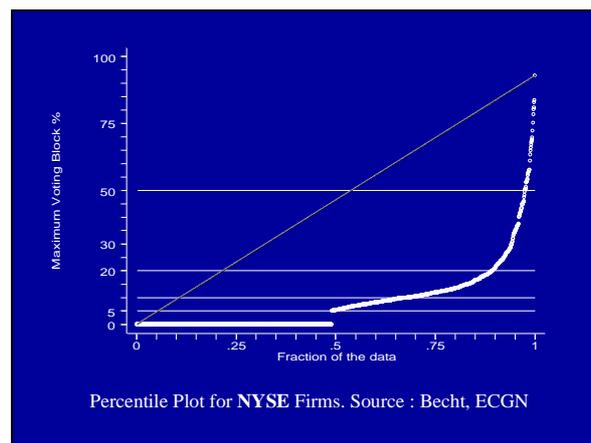
But I think that there is a different view that one might have about those patterns of ownership that I put up earlier. To illustrate this point, I want to describe a few more statistics or results that come out of the analysis of corporate control in different countries. As I was saying earlier on, this is an exceptionally rich source of information that is gradually becoming available in Europe, through the work of the

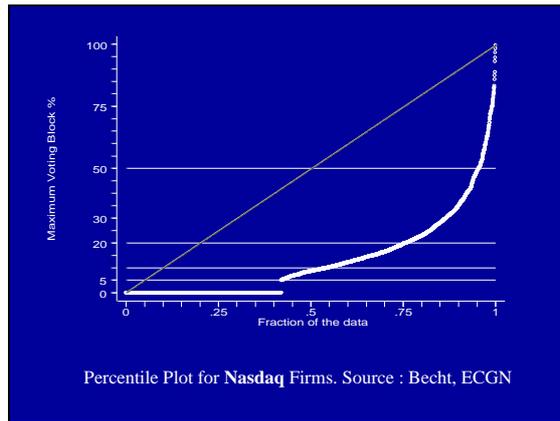
European Corporate Governance Network (ECGN). The results that I will describe will shortly be published in a book by the ECGN (1). What this shows is essentially the cumulative distribution of the largest holdings in listed companies in the UK; it is actually a random sample of listed companies in the UK, about 250 of them.



Slide 8

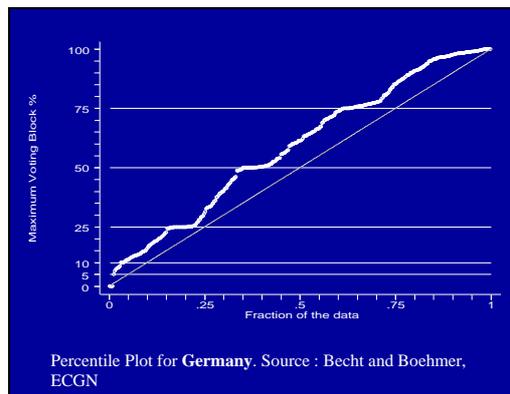
It cumulates up to the largest holdings from those companies which have got small blocks of shares over here (*indicating the left of the diagram*) to those that have got the largest blocks of shares (*indicating the right*). Thus, if there were a uniform distribution, then it would lie basically along its 45-degree angle. What we observe is that for the vast majority of UK firms the largest shareholdings are very small. A vast majority of them lie below 25%, most of them are below 10%, and very few large blocks are above the 25% level. There is a particular significance associated with the 30% level; as you will appreciate, that is the level at which, according to the Take-over Code in the UK, one is required to launch a full bid for a company. So there are very few blocks lying above that 30% level.





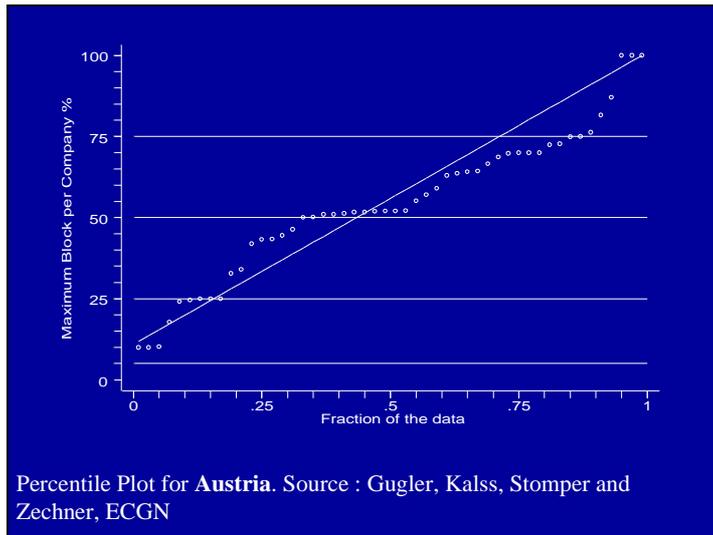
Slides 9 and 10

If you look at the US, the picture looks very similar. As I said, there is a vast number of companies whose largest voting block is actually below the disclosure level. So, according to Becht, the curve for nearly the first half of observations is down at zero, with very few above the 20% level. 20% is significant in the US because it is conventional in the US to regard 20% as being a level of control over the running of the company, which can have significant legal implications associated with it. So there is a very similar pattern of extensive dispersion in the US (as in the UK); and for Nasdaq firms as well as NYSE firms the pattern is very similar.

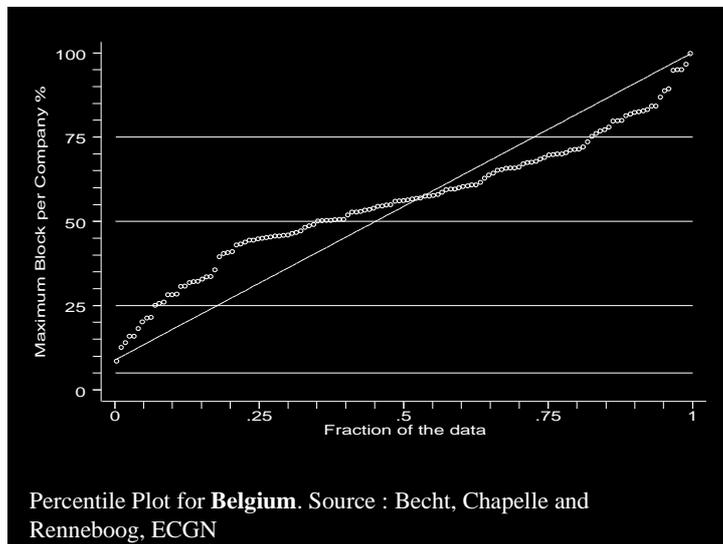


Slide 11

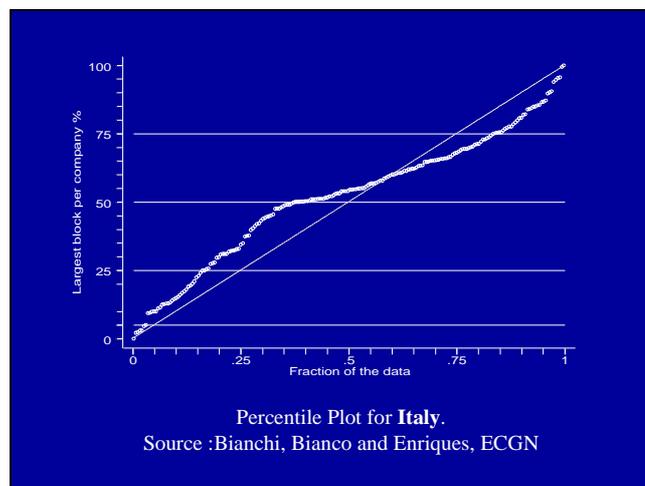
Contrast that with this pattern of German firms, where one observes something much closer to a uniform distribution, nothing like the very dispersed ownership that I had before. What is also quite an interesting feature is that blocks are concentrated around three levels, 25%, 50% and 75%. The significance of these is that, under German corporate law, holdings of 25%, 50% and 75% confer substantial additional control over the running of the company. There are similar sorts of patterns that exist in many countries (shown in Slides 12 to 16 overleaf).



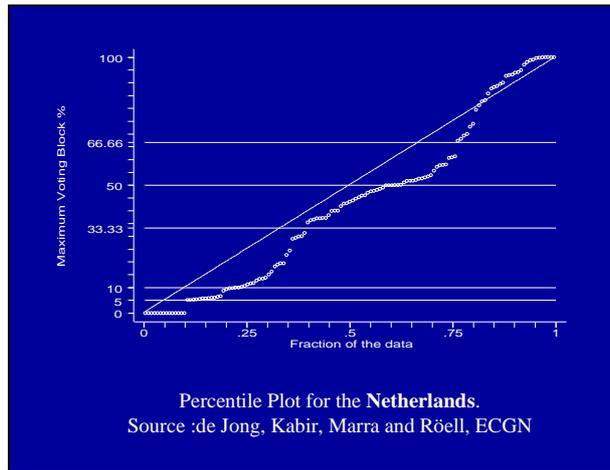
Slide 12



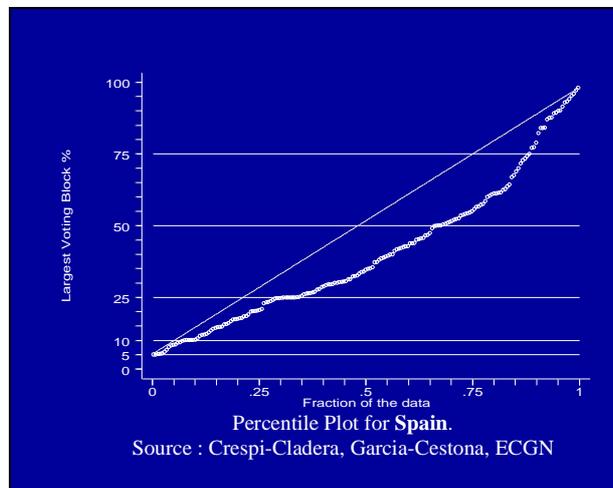
Slide 13



Slide 14



Slide 15

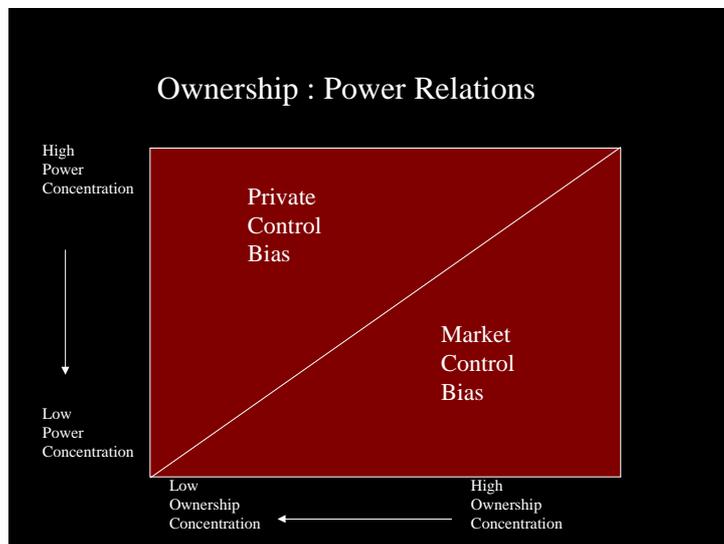


Slide 16

As can be seen, in Austria, similar concentrations to those in Germany arise around 25%, 50% and 75%. In the case of Belgium, minority blockings or supra-majority voting don't confer quite so much control, so it is the 50% level that is rather more significant. In Italy, the picture is rather similar, with slightly more dispersed ownership in the Netherlands, and still more dispersed ownership in Spain. But these are nothing like what is observed in the UK and the US.

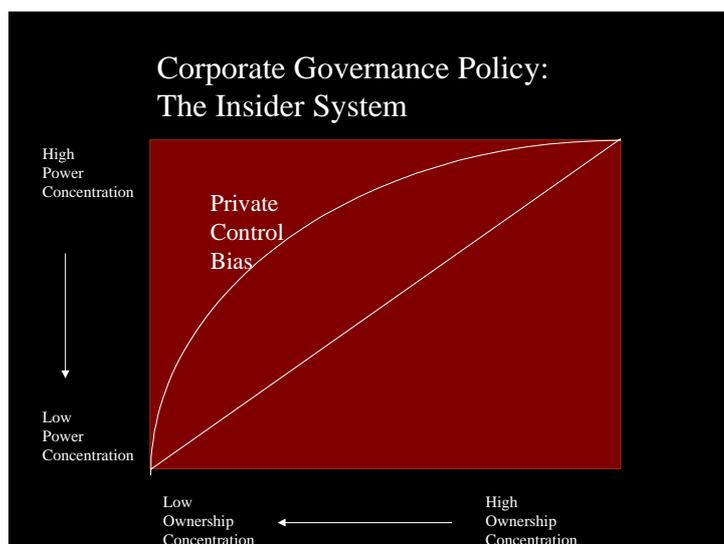
Well, what is the significance of those differences? One point I would like to bring out can be thought of in terms of the life cycle development of a company. Imagine, as an example, a company that is expanding from being a sole proprietorship with one owner – that therefore starts off with a high degree of concentration of both ownership and control of the company. The owner then brings in another investor – it might become a partnership, and some of the equity of the original founder is then shared with someone else. That expands the number of investors. In due course, it reaches a point where the company comes to the stock market. It sells off the shares on the stock market, so at that stage a substantial fraction of the shares is held by outside investors, but still the majority of the shares remains held by the original owners. Eventually, the original owners sell off some of their shares, so at that stage the company becomes

widely held, with a majority of the shares quoted on the stock market and traded freely. Now, if one thinks about this in terms of the selling off of ordinary shares, with voting rights attached to them, as one disposes of ownership one is also proportionately dispersing voting rights in the company.



Slide 17

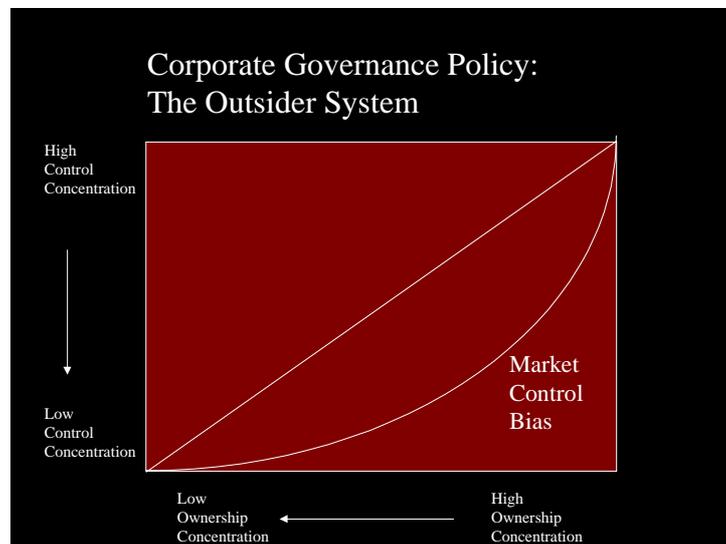
So one is basically moving along that (*diagonal*) line there. In many countries, in the process of selling off shares one does not necessarily sell off shares with equal rights attached to them. Dual class shares are commonplace in most countries outside the UK and the US. What a dual class share allows the vending shareholder to do is to retain control, or at least to retain voting rights, while selling off some of the ownership rights. By ownership rights I mean the cash flow claims on the company.



Slide 18

So instead of moving along the diagonal, one moves in a direction like this (*indicating the upper curve*). Conversely, if one is selling off equity into a market in which there are extensive rules protecting minority investors, then the control of the original

owner is reduced more than proportionately. In particular, rules that confer equal right treatment for minority shareholders in take-overs give rise to the benefits accruing to minority shareholders being disproportionate to their shareholding claims in the firm. That is essentially what we mean by the “free rider” problem in the outsider system.



Slide 19

So that suggests that there are different types of governance arrangements which can be thought of in terms of the mapping of ownership onto control. Under a market bias system, as ownership is sold off then control is more than proportionately dispersed. In a private control or insider system, then, as one sells off ownership, the original owner does not necessarily lose control rapidly. There are a series of vehicles that can be used to retain control as ownership rights are sold. Mark Roe noted – as did Berle and Means several decades before - that the US was down there (*below the diagonal line*) and felt it would be better off up there (*above it*), whilst Shleifer and La Porta argue that most of the world is up there (*above the diagonal*) and would be better off down there (*below it*). By contrast, what I am suggesting is that in fact there is a rather more subtle picture. The way in which different systems impact on the behaviour of companies reflects this entire mapping of ownership onto control or voting claims.

Now, what is the significance of this mapping? Well, as you saw just now in relation to what I described as being the insider system of most continental European and Far Eastern countries, in the insider system original entrepreneurs and owners retain control even as they bring in outside equity and sell off some of the ownership players. And basically what that does is to allow an original investor to retain control over a long period. The ability to retain control over a long period may well be of benefit if the types of activities that are being undertaken and the projects that are being implemented are of long duration. So the private control bias, giving rise to long influence periods, will be of benefit to activities that have long realisation periods. On the other hand, we know that a problem with these systems is that they can give rise to excessively long influence periods – if an inappropriate controller is in place for too long a period, this creates problems of sclerosis.

The advantage of having the market bias is that it allows for a greater degree of flexibility. So the period over which the original owner/entrepreneur can retain control as they sell off equity is relatively short. The short influence periods will be of particular benefit for promoting activities that have short realisation periods - where one is bringing in, for example, a high technology research project which has a short period during which it is either proven to be feasible and to have an economic rationale, or it is not. That sort of activity may well benefit from a short influence period and this avoids the problem of excessively long control by a particular owner. What this is suggesting is that the question about corporate governance, and different patterns of ownership and control, go beyond the traditional debate that I started off by putting up, which is concerned with issues about corporate efficiency and distribution.

This suggests that corporate governance really has quite fundamental effects on what I've just described here as being the relationship between ownership and control. That, in turn, bears on the relationship between what I described as the influence period - the period for which a particular person in control can retain control - and the period for which it is desirable for control to be retained, given the length of time it takes to bring projects to fruition. What this is suggesting, then, is that corporate governance is intimately related not only to questions about efficiency and distribution, but fundamentally to the strategy of companies and the types of activities that go on within an economy.

Now, obviously, this raises the question about whether or not there is any evidence to support this type of assertion of a relationship between different types of systems and different types of activities. What it is pointing to is the notion that different types of arrangements may not so much give rise to absolute advantage, as suggested by Mark Roe and Shleifer. From Mark Roe's point of view, there was an absolute advantage in terms of having good governance and some concentration of control. From the point of view of Shleifer *et al.*, there is an absolute advantage that can be derived from having dispersed ownership and strong investor protection. I am suggesting that there may be not so much a best system but a comparative advantage of different systems with different types of activity.

Evidence on this is really only just beginning to emerge. The paper that I circulated summarises some of the evidence which is beginning to emerge on the subject. (2) This suggests that there may be relationships between these different ownership and control structures and the balance, for example, between research and development and fixed capital formation activity in different countries - and the extent to which different types of industries are promoted in different systems, with skill intensive - and equity financed - industries being badly supported by particular types of ownership arrangements. So there is some evidence that is just beginning to emerge, but it is not a topic that, as yet, has received a great deal of analysis.

So, to sum up, what I've suggested is that there are marked differences in patterns of control of companies, with large voting blocks in the hands of families and companies being dominant on the Continent. In the UK, one can have quite significant levels of control being exercised - but it has to be done through coalitions of shareholders. Whereas there are single blocks that can exercise majority votes or more on the Continent, it takes about six or so shareholders to cast around 30% of the votes on

average in the UK, so moderate size coalitions apply. I suggested that the UK and the US demonstrate a bias towards dispersed control, while something somewhat closer to uniform distribution was observed on the Continent. In other words, there is more in the way of a private control bias on the Continent, and its associated levels of control seem to be concentrated where regulation confers particular control benefits, so that regulation is an important influence on these various patterns of control.

Well, what are the implications, if this is borne out by further analysis? As I suggested, it would suggest a notion of comparative rather than absolute advantage in terms of different systems being suited to different types of economies, with R&D versus fixed capital formation activity. It suggests that different systems may be very much better suited to different stages of development of countries. Whereas it may well be the case that concentrated patterns of ownership are suited to earlier stages of development, there may well come a point at which that no longer is a relevant structure for a country. I suggest that quite a lot of the changes that one observes going on in different parts of the world, most notably in the Far East, are a reflection of the suitability of different types of systems to different types of activity.

That suggests that, in terms of devising one's regulatory and legal system, one has to be sensitive to these relations. What is suited to one developed country may not be suited to another developed country, given a very different industrial base. What is suited to a developing country may well be quite different to what is appropriate for a developed country. But it is quite clear that our ignorance of these relations is formidable. As I was saying, there is very little in the way of evidence on precisely how systems relate to activities, and it will take a great deal of analysis to be able to pin this down with any degree of precision. That suggests considerable caution in terms of trying to come out with policy prescriptions, and what I would suggest as being a preferred form of policy prescription is to encourage experimentation and competition rather than attempting to identify dominant systems that should be implemented universally.

This suggests that regulations should be enabling rather than restrictive, allowing companies to select different types of systems under which to operate and encouraging companies to be able to determine their own particular forms of governance arrangements. It suggests that we should be seeking to achieve competition between systems, rather than harmonisation, and that we really have a considerable opportunity in Europe, given the very diverse nature of the systems that I mentioned earlier on. This is not just a matter of the distinction between the UK, on the one hand, and continental Europe on the other. There is a lot of variation within continental Europe as well as between the UK and the Continent. And that is potentially a source of considerable strength to Europe, if only the natural tendency towards harmonisation can be avoided. The inclination, particularly of the European Commission, to push towards harmonisation of systems is something that, to my mind, is not entirely desirable. The nature of regulations and systems may well need to develop as economies develop.

I've mentioned already the fact that what is appropriate for developing countries may be very different from developed countries, but what is appropriate for developed countries as they develop further may well change. So, the underlying technological changes that have been going on over the past decade mean that the appropriate

structure of governance arrangements that is relevant for high tech industries - and economies that are dominated by high tech industries - is potentially quite different from what is appropriate for more standard, manufacturing industry.

Finally, let me just come back to the policy issues that I raised at the beginning, and my observation about the large number of debates and analyses that are currently going on about British institutions in the UK. A common underlying feature of regulation in the UK is its emphasis on minority investor protection. That really dates back to The Bubble Act of 1720 and it was reinforced repeatedly during the 19th century, for example in relation to the introduction of regulation of banks. This is very much reflected in the structure of regulation in the UK to date, for example, in relation to bank regulation (as Don Cruickshank brought out in his report). There is a particular emphasis on the protection of depositors, protection within the banking system, which has had the very beneficial effect of giving rise to remarkably low levels of failure of British banks in the last century. But, as he notes in his report, this may have had quite serious consequences for levels of competition. Extensive minority investor protection in relation, for example, to new equity issues requires them to be in the form of rights issues, with other provisions addressing pensions and take-overs. The Take-over Code provides extensive protection of minorities once 30% of shares are acquired in a company.

Now that stands in quite considerable contrast to what one observes, for example, in the US where in relation to banks there has been much more diversity - although there has been much more in the way of failure of banks. That is the cost. There has been regulation impeding inter-state banking, but the fact that there has been a greater failure rate has also been reflected in a large number of much more localised, regional, state banks in the US than have existed in the UK. There has been no requirement in the US to make rights issues, and indeed most companies when they make new acquisition do not make them in the form of rights issues. No requirement exists once you have acquired 30% shares in a company to make a bid for all of the shares at the highest price paid, but there is strong legal protection through the courts. That diversity across states in the US, in particular reflected in corporate law which allows a company to incorporate in states with different systems of corporate law, is, I think, potentially a source of considerable strength to the US, and it is something that we have the potential to replicate in Europe if we can avoid the natural tendency towards harmonisation. What I'd much rather see is competition between member states of the EU, trying to encourage them to incorporate in their jurisdiction in the way which one observes competition between states in the US. It may well be the case that investor protection has come at the expense of active corporate governance and the development of the sort of long term relations - the long term influence periods to which I was referring earlier on. Thank you very much. *[Applause]*.

References

- (1) **F.Barca and M.Becht (forthcoming) Corporate Control in Europe ECGN.**
- (2) **Wendy Carlin and C. Mayer (1999) Finance, Investment and Growth CEPR Discussion Paper No.2233.**

Ken Peasnell: Well, I think you will all agree that Colin Mayer has got the proceedings off in excellent style, and he has given us enough to think about in an area of corporate governance that would probably last the rest of the day. But we are going to have to defer discussion until after we have had our next two speakers, so I am going to hand over now to Mike Wright to talk about venture capital.

Venture Capital, exit to market, and conditions for return
Professor Mike Wright, University of Nottingham

Mike Wright: I am going to talk about governance enterprise and venture capital.

**Governance & Enterprise:
VCIs, IPOs & P2Ps**

- Corporate Governance: Accountability & Enterprise
- Enterprise Life-cycle & Governance
 - Owner-managers
 - Venture Capital Investors (VCIs)
 - Flotations (IPOs)
 - Public-to-Private Buy-outs (P2Ps)

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Slide 1

Let me just make a link with what Colin was saying, in that, looking at the role of venture capital firms and leveraged buyout associations, I think we have an issue here to do with active investors in a market based system that may provide some of the flexibility that, in a private control bias system that Colin was talking about, may be absent. I think also, in what I will say, there are issues to do with different types of corporate governance for different types of activity. So, I am looking at a more specific facet of corporate governance than Colin was talking about. And I think, hopefully, you can see some links between what the two of us are saying.

Let me begin by making a link between accountability and enterprise. Then I will talk about these corporate governance mechanisms in relation, first of all, to the managers, and secondly to venture capital investors. Here I am going to talk not just about venture capital firms like Apax, but also LBO firms like KKR. I will talk about IPOs (initial public offerings) and public-to-private buyouts, which are very common currently.

Corporate Governance: Accountability & Enterprise

- Accountability
Cadbury
- Enterprise
Hampel
- Company Law Reform
Retreat from Enterprise?
- Importance of Accountability & Enterprise
(Short, Keasey, Wright, Hull, 1999)
- Mechanisms to Achieve Both?

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Slide 2

Now let me just provide a very brief summary of developments in the corporate governance debate in the UK. I think, without exaggerating too much, that it is fair to say that Cadbury was very much focused on accountability issues in corporate governance. With the progress through Hampel and Turnbull, there was a shift towards an enterprise emphasis in corporate governance. The current debate relating to corporate law reform that Michael referred to at the beginning perhaps raises questions about whether this might mark a retreat from enterprise – that is, the creation of wealth as opposed to the tight monitoring of management. It seems to me that one of the key issues is to create a balance between accountability and enterprise. How can we make sure that management acts in the shareholders' interest, but at the same time are not stifled from innovating? How do we develop mechanisms to achieve both these goals? It seems to me that venture capital and LBO associations may be a way in which we can achieve these two goals.

I am going to look at four dimensions of enterprise life-cycle governance, starting with owner-managed firms, then looking at the incoming role of venture capital firms, followed then by flotation on the Stock Market, and I will spend most of the time talking about public to private deals.

As regards owner-managed firms, clearly we can distinguish between those that are merely surviving and those that are really innovating in a major way - cases where the entrepreneur has what I call an entrepreneurial mind set: that is, somebody who is capable of creating something new as they are able to engage in 'out-of-the-box' thinking. They create the "dot coms" and other really high risk ventures. This raises the question: if these are going to be successful, how do we get the right balance between control of that growth (without stifling the entrepreneur) and pure uncontrolled growth where the business grows very quickly and then suddenly fails? Perhaps the recent failure of BOO.com is an example of what appears, from press reports at least, to be a fairly uncontrolled growth in a very innovative situation.

Enterprise Life-cycle & Governance

- Owner-managed firms
 - Surviving vs. Innovating
 - Entrepreneurial mindset
 - Controlled vs Uncontrolled
 - Few NEDs? More Likely in Technology Sectors (Westhead, 1999)
 - Need for finance and involvement

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Slide 3

Now, one way that control may arise in these situations is through non-executive directors. A recent study by a colleague of mine, Paul Westhead, suggested that in technology based sectors, amongst owner-managed firms we see a much higher incidence of non-executive directors than we do in owner-managed firms that are merely surviving.

If these firms are going to succeed, there is a need for extra finance at some point; they exhaust the resources that they can get from their friends, aunts and grannies. They need to obtain some outside finance and involvement in the monitoring situation. And that is where the venture capital firm comes in. Typically, we can envisage the venture capital firm providing private equity finance, along with a number of monitoring mechanisms that ought to help innovation to occur but in a financially responsible manner. Such mechanisms include the staging of investment payments. Guideposts are set over a period of time, and the investment is staged according to whether these targets have been reached. The venture capital firm may also introduce performance-contingent returns to the entrepreneur. In other words, the entrepreneur does not receive the full equity stake at the start. The equity stake has to be earned according to performance over a particular period of time - venture capitalists refer to these as “equity ratchets”. The equity share may be ratcheted up or down, according to performance. One can also introduce measures in the Articles of Association that give the venture capital firm powers to intervene in the company, whether or not they have a majority of the equity stake. This would mean, for example, that the entrepreneur has to obtain the permission of the venture capital firm to undertake investments above a certain level. These mechanisms are designed to promote responsible innovation.

Enterprise Life-cycle & Governance

- VCI's
 - Staged investments
 - Performance contingent returns (ratchets)
 - Articles of Association
 - Board representation
 - Detailed reporting
 - Frequent contacts (avg 3 times per month)
 - Contracts and flexible relationships

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

Slide 4

Board representation is also a common feature of venture capital monitoring. It is usually a condition of the investment, although it does depend on the venture capital firm. The venture capital firm also has the power to require much more detailed, and much more frequent, reporting than is the case with a listed company. For example, the venture capital firm would have the power to obtain access to monthly accounts and it can specify the form of reporting. Contacts between the venture capital firm's executives and the investee are also going to be much more frequent than in a listed company. Studies suggest that on average three times a month there will be a link between the venture capital firm and the investee. What I have described suggests that this governance process involves a mix both of contracts – the first three are really contractual arrangements - and flexible relationships between the investee and the venture capital firm. The two aspects of monitoring are related, because evidence suggests that contracting without relationships does not work and relationships without contracts are a recipe for disaster.

Role of Venture Capital Firms

Role	Score
Monitoring Financial Performance	4.5
Sounding Board for Management	4.1
Monitoring Operational Performance	3.5
Searching for Debt	3.4
Managing Exit	3.3
Searching for Equity	3.2

Score 1-7; extent of VC influence

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

Slide 5

The kind of areas in which venture capital firms are involved is reflected on Slide 6 (*below*), which is part of a recent study I conducted that looked at recipients of venture capital investment. The study asked entrepreneurs to score what they saw as the important aspects of the role of venture capital firms. The area of greatest importance relates to the monitoring of financial performance, followed by the advice that the venture capital firm can offer as a sounding board for management.

Enterprise Life-cycle & Governance

- VCI's

Added value highest when:

- Innovation high
- High frequency & openness of interaction
- Low conflict between VCIs & entrepreneurs

(Sapienza, 1992)

Limited time horizon

Venture-backed IPOs outperform Non-venture-backed IPOs (Brav and Gompers, 1997)

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Slide 6

We therefore have a combination of both financial governance and much deeper involvement than would be seen in the monitoring by institutions of listed companies. The value-added arising from the involvement in governance of the venture capital firm will occur where innovation is high and where there is uncertainty. The entrepreneur needs the extra skills that the venture capitalist can bring and there will be benefits where there is a high frequency and openness of interaction. If the venture capital firm only provides financial control on a monthly basis - that is, if they are quite distant - its contribution is unlikely to be specific enough to help improve the performance of the firm. Of course, venture capital firms want a return for their money, usually within a particular time scale, because very often their funds have a limited time-horizon. Closed-ended venture capital funds typically have a life of about 10 years, within which it is necessary to exit investments. This obviously poses important governance questions relating to how the venture capital firms will monitor their investees. But it also suggests that we are talking about situations where venture capital is appropriate for a particular life-cycle stage of an enterprise. There will come a point at which the next stage in governance is required.

There are various ways to exit from venture capital investments. Perhaps the obvious route is through a flotation on the Stock Market, although this occurs in few cases. Indirect evidence of the way in which venture capital firms add value was provided in a recent study by Brav and Gompers. This study suggests that flotations that have been venture-backed significantly out-perform flotations of companies that have not been venture-backed, indicating that something is happening in the governance process that is helping to add value to the business.

Enterprise Life-cycle & Governance

- IPOs

- Increasingly, too small for institutions
- Too small for analysts (tracking costs)
- Fewer NEDs, less effective audit committees (Collier, 1997)
- Ineffective takeover market
- Reduced involvement of Venture capitalists
- Illiquidity & difficulties in raising finance
- Floated buy-outs outperform sector, but difference disappears over time (Holthausen & Larcker, 1996)

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Slide 7

Looking at companies that have come to the market that had previously been venture-backed IPOs, we are starting to see that many of them are now too small to be attractive to financial institutions. This particularly applies to those that are not high-growth companies. Secondly, many of these companies are also too small or too illiquid to be of interest to investment analysts. Evidence from Paul Collier also suggests that, in accordance with Cadbury, these companies tend to have fewer non-executive directors, and that crucial elements for effective audit committees were absent. I think it is also fair to say that external governance mechanisms, such as the take-over market, are also quite weak in these companies - perhaps even weaker than for larger companies, because the companies are too small to be of interest to an acquisitive company. As these companies list (*on the Stock Exchange*), venture capitalist investors are going to exit over a period of two to three years, so that any residual involvement from the active investor is slowly eroded. We are thus faced with a situation of poor governance, illiquidity of shares, and difficulties in raising finance. I think that it is also worth pointing out that management buy-outs that have been floated do tend to out-perform their sector, but that the difference disappears over time. A study by Holthausen and Larcker in 1996 provided good US evidence regarding this effect.

Let me now turn to Public-to-Private cases, that is taking a listed company private. Here we have a situation of illiquid shares. Many of these companies are floated management buy-outs with nowhere to go; they are not growing; and they are too small. Perhaps the companies have problems and need to re-structure in private. If they take themselves private they could save themselves the costs of being listed on the market. I think it is also fair to say that what makes Public-to-Privates feasible is a reduced suspicion of venture capital firms by institutional shareholders and management.

Enterprise Life-cycle & Governance

- P2Ps

- Illiquidity

- Floated MBOs Nowhere to Go

- Better to Restructure in Private

- Save Market Costs (£0.5 m)

- Reduced Suspicion of VCs by Institutional Shareholders and Management

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Slide 8

The current growth of public-to-private buy-outs is part of a very buoyant management buy-out market. Last year alone, £8.4 billion worth of private equity funds was announced, with £4.1 billion raised. Adding to these figures the leverage going into these deals and the equity available from captive venture capital funds, an enormous amount of funding is available to fund these buy-outs. There are also US buy-out firms targeting Europe: £2.4 billion was raised last year by them as well. The funding is there to support public-to-private deals, and specialist expertise has now been developed amongst venture capital firms and LBO associations. This expertise has been developed both by UK players and by US firms entering the market, like KKR; Hicks, Muse; Texas Pacific; Carlyle, and so on.

Public to Private Buy-outs

- Funding Availability for MBOs

- UK funds announced in 1999

- £8.4 billion

- £4.1 billion raised

- In addition US funds targeted at Europe

- £2.4 billion raised in 1999

- Specialist Expertise Developed

- UK players (e.g. Alchemy)

- US firm entry (KKR; Hick, Muse; Texas Pacific)

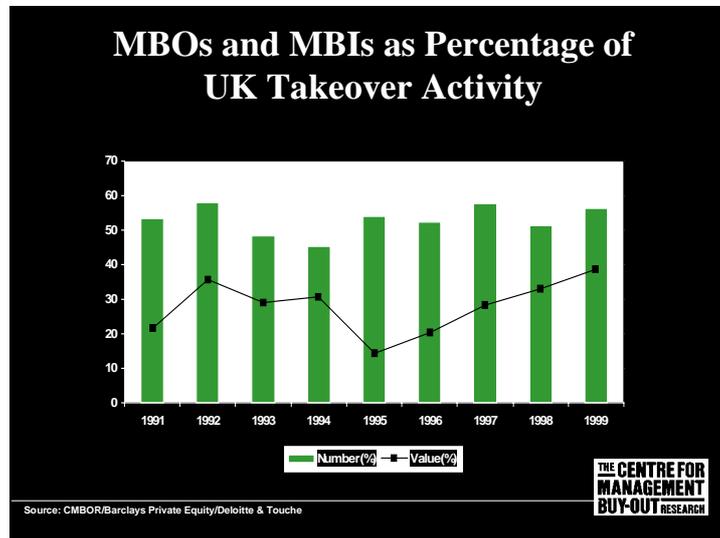
Source: CMBOR/Barclays Private Equity/Deloitte & Touche

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

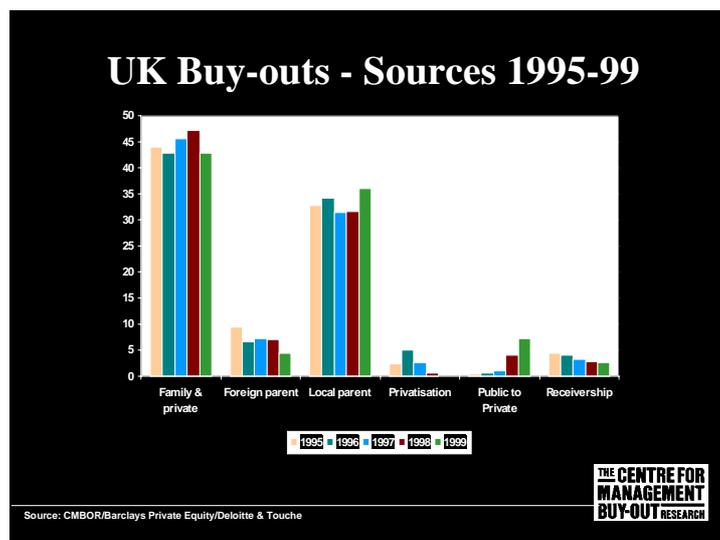
Slide 9

Looking briefly at the UK buy-out market, it is clear that the market is very buoyant. Last year that market exceeded £16 billion, the highest it has ever been, and it shows

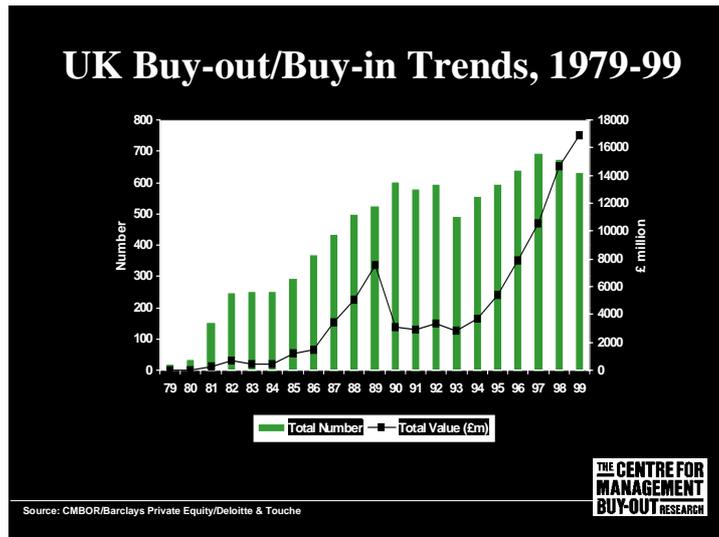
no sign of retreating. Buy-outs have become a very significant part of the overall market for corporate control. Over 50% of ownership transfers in the UK relate to buy-outs and, as a fraction of the value, almost 40% are buy-outs. These deals, therefore, potentially have a very important role to play in the governance of enterprises in the UK economy.



Slide 10



Slide 11



Slide 12

Buy-outs come from a number of different sources. Focusing on the public-to-private deals, although they are a minor part of the market, they have shown a strong increase over the last three years. Last year, there were £4½ billion worth of deals involving public-to-private transactions in the UK; that is about 30% of the entire buy-out market. Hence, although in numbers terms they are relatively modest, in value terms they account for a remarkable share of the market.

Top Ten UK Buy-outs in 1999

Buy-out name	Value (£m)	Vendor
Avecia	1362	Astra Zeneca
Punch Taverns	825	Secondary Buy-out
William Hill	825	Secondary Buy-out
Hillsdown	822	Going Private
Sears	549	Going Private
Oewen UK Limited	510	Oewen Financial Corp
Pentland	500	Going Private
Invensys Paper Technology	491	Invensys
Money Store	340	First Union Corporation
Precision Engineering	322	Coats Viyella

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

**THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH**

Slide 13

Examining where the largest buy-outs come from, it is evident that of the top ten buy-outs last year, three were public-to-private deals: Hillsdown was the subject of a contested buy-out; Sears was subject to a hostile public-to-private deal; and Pentland was a friendly deal. To acquire these deals, bidders are paying a premium approaching 50% of the existing share price. The premia are increasing over time as financing institutions are beginning to realise the latent value in these companies, and are forcing the price up. Correspondingly, the amount that venture capitalists can obtain in terms of irrevocable undertakings before they launch a bid, to try and reduce the

risk of failure, is going down. Hence, these deals are becoming more difficult to achieve, even though there is a lot of interest in them.

UK Public to Private Deals, 1997-2000

Year	No. of deals	Total Value (£m)	Average Bid Premium	Average Irrevocable Undertakings
1997	7	389	33.8%	49.3%
1998	27	2650	42.6%	46.8%
1999	45	4616	48.2%	42.2%
2000*	14	3150	N/A	N/A

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

THE CENTRE FOR MANAGEMENT BUY-OUT RESEARCH

Slide 14

As for the sectors in which they are occurring, over the last three years (when the level of interest has been highest) most have been in business services, with many of them in traditional sectors - like mechanical engineering and electrical engineering – but some also in banking and insurance, paper, printing and publishing, retail distribution, and wholesale distribution. We can see that these transactions apply across a wide range of activities; they are not just constrained to traditional, mature, low investment “going nowhere” cases.

Public to Private Buy-outs Industries 1997-99

Sector	Number	Value (£m)
Business Services	13	1,135
Mech Eng	8	493
Elec Eng	7	343
Banking, Ins.	5	1,127
Paper, print, publg	5	168
Retail Dist	5	1,368
Wholesale Dist	5	281

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

THE CENTRE FOR MANAGEMENT BUY-OUT RESEARCH

Slide 15

Amongst the notable deals so far this year, United Biscuits went private, with two financial buyers involved and a link with Danone - an interesting strategic and financial combination. What is also notable is that the buy-outs of Sanderson and Q Group involve software companies.

Notable Public to Private Buy-outs 2000 to date

Deal	Value (£m)	Comment
United Biscuits	1,500	2 Fin. Buyers + Danone
Wassell	627	Lighting, etc.
Waddington	318	Packaging
Sanderson	115	Software
Wardle Storeys	114	PVC, etc.
Q Group	27	Software

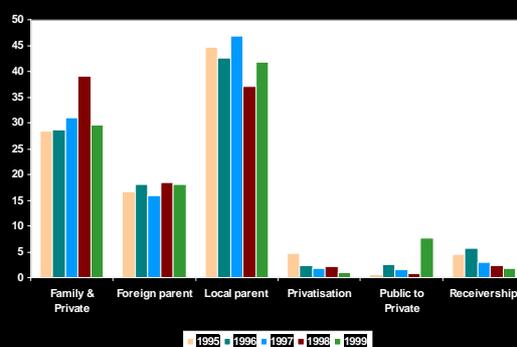
**THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH**

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

Slide 16

The rise of public to private deals is not just a UK phenomenon. It is worth bearing in mind that we are seeing a considerable increase in public-to-private buy-outs in Continental Europe: from four in 1998, to 24 deals last year. This does not seem much in numbers terms, but compared to what was thought to be feasible two or three years ago it is a remarkable change, and it reflects major changes in attitude towards corporate governance.

European Buy-out - Sources 1995-99



**THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH**

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

Slide 17

Considering the corporate governance dimension in public-to-private buy-outs, it seems we are starting to see three distinct categories where the public-to-private buy-out can apply, and where the corporate governance relationships of venture capitalist and LBO associations may be relevant. I would term these (i) efficiency or classic buy-outs, (ii) revitalisation buy-outs and (iii) entrepreneurial buy-outs.

Public-to-Private Buy-outs

Efficiency (“classic”) buy-outs

Stable cash flow, mature sectors, saleable parts, scope to restructure

Revitalization buy-outs

Incremental innovation

Entrepreneurial buy-outs

Major innovation &. “Busted Techs”

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Slide 18

Efficiency buy-outs are traditional buy-outs, with stable cash flows in a mature sector, where it may be possible to sell off parts of the company and where there is scope to restructure the business. A typical case is the buy-out of RJR Nabisco in the U.S.. We are also seeing situations where buy-out types of governance arrangement can be applied to businesses where some level of incremental innovation is applicable, as well as cases where major innovation is possible. I would term this latter group “busted techs” – that is, cases where innovation is possible, but things have run into trouble.

Governance in Efficiency Buy-outs

- Managerial equity stake aligns incentives
- LBO associations with financial control
- Commitment to Service High Debt & Quasi-Equity/Debt
- Monitoring of covenants
- Constraints in Articles of Association

- E.g. Safeway (US)

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Slide 19

I have examined these three cases in more detail in a forthcoming paper in [The Academy of Management Review](#). In efficiency buy-outs, we might expect an appropriate governance and incentive structure to include a significant managerial stake that aligns incentives with managerial performance, in situations where management had little equity to start with. In this situation, the LBO association provides financial control techniques, high leverage, and a commitment on the part of management to service the bank debt covenants, and constraints in the Articles of

Association. In essence, this means very close financial control arrangements, as well as the alignment of incentives. Classic cases include the Safeway buy-out in the US, RJR Nabisco, and so on.

Governance in Revitalization Buy-outs

- Long term equity
- Flexible leverage
- Venture capitalists/LBO association with:
financial control skills

- Managerial mindset - managerial discretion for renewal
 - E.g. Unipart

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

**THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH**

Slide 20

In cases where there might have been scope for innovation and investment, but it was impossible to raise finance on the Stock Market, it may be possible to construct a situation with long-term equity incentives for management, but also more flexible leverage. Instead of including considerable straight-forward debt or junk bonds in the deal, quasi-debt may be used, where the repayment terms are much more flexible, so providing scope for the investment. The venture capitalist and the LBO association, with their primarily financial control skills, still have a major role as there is a need to monitor the business so that it can service its financial commitments. In this situation, the aim is to give managers with a more managerial mind-set discretion to make innovations that was previously absent. The classic case in the UK, perhaps, is Unipart.

Governance in Entrepreneurial Buy-outs

- Long term equity incentives
- Flexible leverage
- Venture capitalists/LBO associations with:
financial monitoring skills
technical skills to add value

- Entrepreneurial mindset for innovation
 - E.g. Zilog; Big On-line (US); Sanderson, Q Group

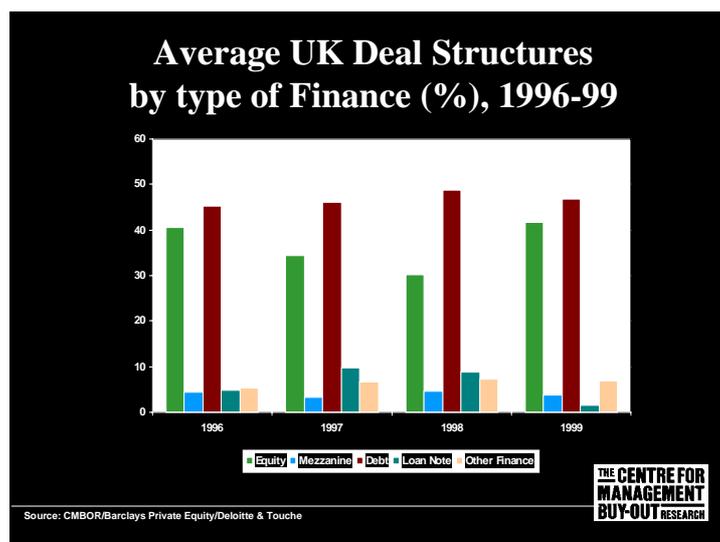
Source: CMBOR/Barclays Private Equity/Deloitte & Touche

**THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH**

Slide 21

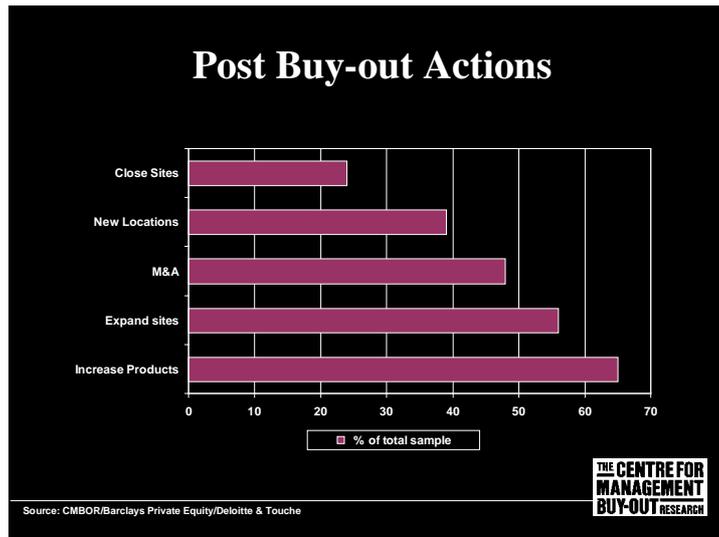
In terms of entrepreneurial buy-outs, the situation involves long term incentives, flexible or perhaps lower leverage, and a requirement for the venture capital firm and the LBO association to have both financial monitoring skills and also technical skills in order to add value. The financiers need to know something about the industry, rather than simply how to interpret the management accounts. This situation involves a match between more flexible governance and incentive arrangements and individuals with an entrepreneurial mind-set necessary for innovation. Cases like this in the US include Zilog, a computer software manufacturer that hit on hard times and has been restructured, and Big On-Line, a web site company. Both of these involve entrepreneurial situations, but a necessity for financial control from the venture capital or the LBO association. Sanderson and the Q Group are similar deals in the UK. This kind of deal takes the market beyond the traditional buy-outs associated with mature, perhaps declining, sectors to the more innovative areas of the economy.

The market is starting to see more buy-outs in the software, hardware, internet and telecommunications sectors. This development is blurring the boundaries between the traditional venture capital areas and traditional LBO associations to create potentially very important incentive and governance structures. Leverage in these deals is coming down, giving scope for greater flexibility in order to innovate.



Slide 22

The actions following completion of the deal involve both restructuring and growth-related activities. This in marked contrast to previous years.



Slide 23

These buy-outs raise a number of governance issues. Clearly, there is a need to convince institutional shareholders and blockholders that buy-outs are going to create value. This introduces a very important role for the non-executive directors. Typically, in these deals, an independent board has to be established to ensure the deal is in the best interests of the existing shareholders. A very important role is also placed on the management team, as they provide access to information. Questions are also raised about whether these deals are a way to replace under-performing management in a way that institutional investors, who are not directly involved in the company, or a weak take-over market are not able to do. We are beginning to see some hostile and contested buy-outs, but these remain rare.

Public to Private Buy-outs

- Management & Governance Issues
 - Attitude of:
 - Institutional Shareholders
 - Blockholders
 - Agreement of NEDs
 - Independent Boards
 - Management Team
 - Information Access
 - Replace?
 - Hostile & Contested

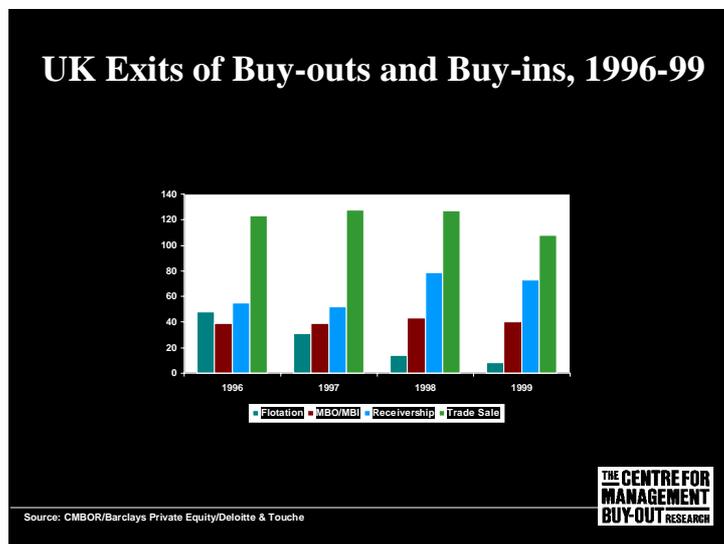
Source: CMBOR/Barclays Private Equity/Deloitte & Touche

**THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH**

Slide 24

Of course, public-to-private deals raise questions about their sustainability the long term. Venture capitalists have their investment life cycle as they need to realise their investment at some point. This raises issues about how restructuring is to be successfully achieved, and also how realisation is to be managed. These are questions that have not yet been fully answered.

Exits of buy-outs can be through trade sale, flotation, receivership or secondary buy-outs. Flotations are becoming very difficult for these kinds of operation. Of the public-to-private buy-outs that have occurred over the last 15 years, relatively few have yet exited, and very few indeed through flotation. Buy-out flotations, currently, are very much limited to internet publishing and software type companies. Indeed, buy-out flotations, as a percentage of all flotations, have dropped to their lowest level for almost a decade. As a result, there has been a shift in realisations, particularly at the large end of the market, to exit through secondary buy-outs involving sale from one venture capitalist to another. This may herald a new, longer term, form of governance whereby firms do not just remain with one venture capital firm for ever. Rather, the company is transferred to another venture capital firm who thinks it can add some extra value. This maybe is one way of providing continued active investor involvement whilst allowing the initial venture capital firms to exit.



Slide 25

Exits from Public to Private Buy-outs

Exit	85-90	91-95	96-00
Float	7	1	0
Sale	8	1	1
Second MBO	1	1	1
Failure	7	3	1
Other	0	0	3
No Exit	15	11	87

**THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH**

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

Slide 26

1999 Buy-out Flotations

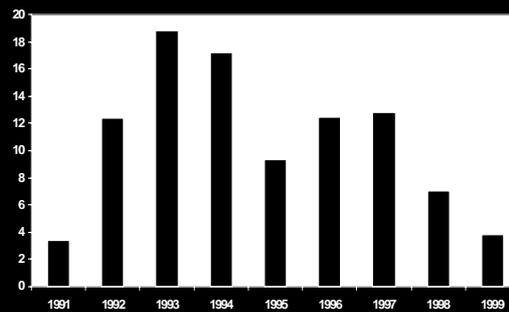
Buyout Name	Value on exit (£m)	Year of deal
Synstar - Granada Computer Serv.	268	1997
Morse Group	305	1995
Future Publishing	526	1998
The Exchange	383	1998
Blooms of Bressingham	12	1999
SDL Limited	45	1997
Peacock and Millets	150	1997
Advanced Telecomms. Modules	N/A	1995

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

Slide 27

Buy-outs as Percentage of All London Stock Market Flotations



THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

Slide 28

Major Non Float Exits in 1999

Transaction	Value on exit (£m)	Year of Buy-out	Purchaser
William Hill	825	1997	Secondary buyout
Punch Taverns	825	1997	Secondary buyout
Sears	547	1999	Various
Thomson Directories	220	1997	Secondary buyout
Personal Hygiene Services	215	1995	Secondary buyout
AM Paper	192	1997	SCA (Sweden)
Defence Eval. & Res. Ag.	145	1997	Amey
Avebury Inns	130	1997	Secondary buyout
Tunstall	123.5	1998	Secondary buyout

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

Slide 29

Conclusions

- Need to balance accountability & enterprise
- VCI's and Buy-out Investors can provide both
- Approaches increasingly apply to efficiency & entrepreneurial situations
- Need for financial control and technical skills of VCI's and Buy-out Investors
- Life-cycle of governance

THE CENTRE FOR
MANAGEMENT
BUY-OUT RESEARCH

Source: CMBOR/Barclays Private Equity/Deloitte & Touche

Slide 30

To conclude, I think in corporate governance we need to balance accountability and enterprise. I hope I have made a case that venture capitalist investors and buy-out investors can provide both accountability and the means to achieve enterprise. These approaches, I think, are also now of wider applicability, going beyond moves to increase efficiency to more entrepreneurial situations. But they do raise big question marks about whether venture capital firms and buy-out investors possess the right kind of technical skills, in addition to financial skills, to be able to fulfil this role. In my view, this remains a big unanswered question. Buy-outs emphasise the notion of a life cycle of governance. One form of governance may not be appropriate at all stages in a business's life cycle. Therefore, we need to develop mechanisms by which enterprises can easily adapt their governance arrangements to suit their life-cycles phases. Thank you. [*Applause*]

Ken Peasnell: I think you will agree that Mike Wright has drilled down, if you like, into the broad picture that Colin (Mayer) gave of European governance and practice, and told us a lot about market support and control in the UK. We have a break now, then I need people to reassemble at 11.45 so that we can hear Nigel Macdonald and have our panel session. You will have to bottle up any questions you have this morning till then. Thank you.

[*MORNING BREAK*]

Ken Peasnell: The last speaker this morning is Nigel Macdonald from Ernst & Young. He is going to talk on the Combined Code. We have now had the economics; I am not quite sure if it is correct to say that we are going to get the law now, but anyway we are going to get the bit that is going to connect us, I hope, to the company law review issues that are stressed for the rest of the day.

The Combined Code - What Next?

Nigel Macdonald, Ernst & Young, London

Nigel Macdonald: Good morning, everybody. In tackling the subject “What Next”, a little humility is in order. I was a member of the Cadbury Committee, and I have stayed involved in the world of corporate governance, as joint author of the report to the EC, and I contributed to the OECD work which led to their code. That does not make me able to tell you with any authority what will happen next, but what it does do is to give me a little understanding of the forces that have led to the present state of development. As a result, I can tell you about them and then stand back with you and think about what they mean for the future. So that’s what I’m going to do this morning.

I want first of all to look at the UK and how we came to get the Combined Code. Then I want to look at how the OECD came to develop theirs, because that has been driven by a completely different set of things. And that is incredibly important in order to understand what their game is about, and why it is now an international issue. Then I want to change tack, for a very good reason. I want to pause for a few minutes and look what a company is and what it is not, because unless we remind ourselves of those simple truths we will not be able to see through the smoke of confusion caused by so many different corporate governance initiatives. Then I want to go quickly through the structures of what I am calling “The Combined Combined Code” - that is to say, the OECD’s code and our own - because we are not on an island here any longer, so that you can see the combined structures very clearly. From those inputs - why we are where we are here in the UK, and why the international journey is underway; what a company is and is not; and the elements of the code - I then want to draw some conclusions about the shape of future developments, and that is how I plan to cover the topic that I have been given.

Now the background to our combined code. Well, the background to that, of course, starts with Cadbury, and it is widely – but wrongly - thought that the driver for Cadbury was Mr Maxwell’s inability to swim. [*Laughter*] Actually, that is not true. The reason you do not know a lot about the background is because it was not background at the time that those who were initiating it particularly wanted to have talked about. I can honestly say I know, because I was there at the very formulation of it. The early part of governance was very accounting-related, and here is why. In the late ‘80s, some of us were getting very worried that accountants and particularly auditors had lost control; now, I do not mean that we are control freaks in the best Blair style, but that accounting standards had ceased to bite. In fact, the corporate governance initiative came at about the same time that the DTI was getting its act together in changing the whole way that accounting standards were written. But, although we could see that DTI was fixing this with the Financial Reporting Council, we could also see that there was a huge imbalance between the power of auditors and the power of boards. And the essence of corporate governance - believe me, I was there - was to try and get the board’s responsibility re-emphasised; it was not just for accountants and auditors (because we hoped we were not so myopic as just to be selfishly concerned for ourselves), but for what a board was actually about.

If you looked at the funding of Cadbury, you would find this drive by accountants reflected in the funding. But, of course, if we were just accounting profession-driven, everybody would have seen straight through it. So we had to get other backing. That was the driver. Now, I do not know how many of you saw Rory Bremner's programme "Where did it all go wrong?". The point is not that Rory Bremner is actually going to bring about the end of this government - of course he is not: but he has captured something at the turn, and it is brilliantly funny. I am not being political here; it is also just as brilliant a parody of Blair as it is a brilliant parody of Hague. This is not a political point. I am thinking about catching something at its turn. And as it happens, Cadbury and the work we were doing caught the mood at the turn, thanks to Robert Maxwell and other things. But, actually, we were already well on the way, months before Maxwell took his swim, so when we came out with conclusions and recommendations, everybody was ready for a change.

Now, what was the background to Greenbury? Well, the utilities had been floated, and there was an absolute fuss about executive pay. I do not think we have solved executive pay yet. As a matter of fact, I do not think that we will solve executive pay in my lifetime - and I am hoping to live a day or two longer. But that was the driver. Government passed the ball to Richard Greenbury, who might have been better employed doing the things he was supposed to be doing, and he came up with a set of proposals which produced, for some companies, seven pages of disclosure about directors' remuneration. That was the driver for Greenbury.

Then we had Hampel. Well, the reason we had Hampel was because there was a clause that we put into the Cadbury proposals, and I take some of the blame for that. I reckon that you never get it right first time. Incidentally, I never get it right second time either! But I was convinced, and so were one or two others when we talked about it, that we were absolutely in need of some sort of revision of Cadbury so that when we could see how it was working, we could modify it. One of the great mistakes that I've seen made is when you produce something - lay it down so that it becomes a binding requirement of some sort or another, or professional guidance or whatever - and it is not changed. After a time it loses its relevance because it is no longer seen to be state of the art - it is seen to have flaws. So we put that in as one of the key recommendations. And since the report had been accepted by the folk whom we had managed to get to sponsor it, that had to happen.

Finding somebody who could do it was difficult. Ronny Hampel took it on, and if you look at the words he used, and I watched them very carefully at the time, he said: "we must get out of this ruddy box-ticking exercise". Do you remember that phrase? He found himself commissioned to carry on with corporate governance, but trying to make it more acceptable. Very early on, for example, he said: "the requirement for auditors to look at internal financial control as well as the board is very onerous, and we will probably look at that - we might want to put it aside".

What has he done? Although he removed the requirement for auditors to report publically on internal control matters, he not only kept the provisions for internal financial control but he added on the whole of risk management, right across the whole business. I am not at all uncomfortable with what he came up with; I think he did a superb job. But let us be clear; I think that when he took the task on, he wished

he had not got it. I think he went through an enormous learning process in chairing that working group and he ended up buying into some of the things that, if you look at his early press statements, he was clearly not happy with. And that is how we got the “Combined Code”. I have told you about the revision clause in Cadbury, and why it gave rise to Hampel. There is no revision clause in the Combined Code, and therefore there will not be a new combined code until this one has gone – until it has hit some rocks, or legislators want to fix it. There is no self-improving process in this Code, which is a pity. I wish they had picked that bit up from Cadbury, because you need a process that keeps something defining “best practice” and keeping it up to date.

The other change that is coming is the company law reform. As you are going to have some bits this afternoon, I am not going to go into that area. I think, from the UK’s point of view, it is useful just have those factors in mind as to how we got to where we are. But, interesting as they may be to one or two of us, that is nothing like as interesting as how the OECD came to be where it is at.

There has been an industry created by corporate governance – it is absolutely staggering; I wish I had bought shares in it on day one, you know! Until about the time of the second World War, I believe that most Western governments would have seen their role as being a combination of foreign policy, defence, home rule and social harmony (however that might have been defined). The job of the minister responsible for the Treasury, here the Chancellor, would have been to raise enough cash to achieve those ends in a way which did not cause social disruption. It was a “balancing of the books” exercise. Very little reallocation of wealth took place, except to the poorest in some societies. Managing the exchequer involved trying to achieve a sound balance between the many conflicting objectives - and if you listen to Gordon Brown, you would appear to have him saying that that is his main job. It is not. Since 1945, a most remarkable change has occurred right across the Western-approach capitalist world. I think it is a change initiated by Keynesianism, which was first adopted by Roosevelt and the New Deal. That was a huge experiment: “everything else has failed, but why not try this? We must as well go bust in style!”. It worked. The level of unemployment fell, and the economy recovered.

Since then, governments have learned that they can actually manage an economy; it does not need to be left to “happen”. They squeeze what they need to squeeze out of it, and they can manage it. I think the best example of that is when Bill Clinton was standing for election, the first time he went for the presidency. If you remember, he had a standard catch phrase. He would be asked a question - it might be about education or whatever – and he would reply: “the answer is the economy, stupid!”. That is a massive change. We have all seen it in our lifetimes, and it is significant to the issue of corporate governance. The need for internal competitiveness has become driving now, as a result of the other major change, which I will not bore you with because you all know about it, which is the liberation of international capital markets. The move away from closed economies with exchange control and some trade across the edge into, relatively, a free trade world is driving us towards the need for effective management of companies internal to an economy. That is an absolute imperative now, so that our own companies are competitive. I am saying: “our own”, but I do not just mean “British”. If we were speaking in Holland, we would say the same thing, and if we were meeting in South Africa, we’d say the same thing. We must make our

own companies - our own economy – competitive, otherwise we simply get washed away in this new international trade game. I would say so dramatic has been the change that even political parties whose *raison d'être* was reallocation of wealth have had to reinvent themselves - you can't guess which one I'm talking about!

Now, I am not trying to give you a history lesson; that would be insulting. I am not a historian anyway. But what I am trying to do is to point out why corporate governance has become so important. Most governments have at least dabbled with public sector management of commercial activities. Every single one has failed, I think most dramatically in the communist block. As a result, all Western governments have now come to see the company as the key engine of economic growth, and that is why they want their companies to succeed. That is why the OECD, which represents most economies in the world - I mean, well over 100 economies - has come up with guidelines for corporate governance. These are not stupid folk, based in Paris looking for things to do. They are actually a very clever group of people, and they are interested in making sure that, as world trade mushrooms, it does so on a basis which does not lead to strains or even the collapse of some economies. That is the driver.

That is why what started here as the Cadbury Committee work has become an unstoppable force for reform in the way companies across the world are governed and managed. We do have a lead in corporate governance here, and I think in the States in different ways - although some of the bits of States are appalling in corporate governance. But it would be a great mistake to think of this simply nationally, as a UK issue. It is not: it is a world wide issue, and I want to come on to that in terms of "Where next?". Now the change in thinking is causing people to ask different questions like: "What went wrong with the corporate governance process at Marks & Spencer's, or at Cable & Wireless, or Barclays?". Old style questions would have been: "how on earth did Sir Richard Greenbury get it so wrong, or Lord Young?". We are looking at the process now; that shows that the debate has changed. The change in thinking is causing people to recognise that even the very best executives are human, and they do make mistakes. People are increasingly asking about the role of the board as a whole, and the independent directors, and so on. Are the executives being properly challenged? Is the strategy right? Is the company controlled and managed properly? How does it come that a large business can get it so wrong? Now all these questions of processes are vitally important and we will come back to them.

We have reminded ourselves why corporate governance in the UK is in its current state, and why there is now widespread international acceptance of the need for effective corporate governance. The next bit of the logic is to stop there for a moment, and take a step sideways to remind ourselves what a company is and what it is not, if we are going to try and understand the internal drivers of corporate governance.

A company is not a natural thing. The 1720s has already been referred to by Colin (Mayer), but it is worth reminding ourselves that the collapse of the South Sea Bubble was such a seriously bad bit of news that it was made illegal to form a company after it, unless you got a special act of parliament to allow you to do so. That is how dangerous a company was. I mean, today's sort of thing might be a bit like an internet virus, if we could legislate against it. A company may have, and indeed does have, a

legal persona, but, unlike you and me, it is not self-correcting, nor does it learn from its mistakes, nor is it in any way self-perpetuating. Of course, I am not self-perpetuating, any more than you are. But if children appear, there is a sense of self-perpetuation, and family businesses often take that into account. But a company is not like that. It is simply a vehicle for people to come together and do business that is much more flexible than a partnership or a joint venture.

As such, it needs constant direction and guidance. It also needs constant renewal of talent, ideas, and people. Now, from the outset it has been recognised that a company runs best if it is combining entrepreneurial drive with discipline. This is the very issue of the balance between entrepreneurship versus control. That is not a new thing. The many aspects of a business require a combination of talents that is rare to find in any one person, even Richard Branson. Secondly, the traditional model of a company is not the one that Britain became so familiar with in the 1950s to early 1990s, namely a company that is run by executive directors. That is not the traditional model. The traditional model is one where the company is directed by a board of non-executives, with a general manager or a managing director responsible for the executive functions. That pattern never changed in banking, which is why you've still got it in banking and the building society world. It did not change in the States; that is why you have got it in the States. It is only from the Second World War until about ten years ago that it changed here. And, of course, in Germany you have the same concept: the supervisory board is not the executive board. So, getting the role of the independent director in context is important.

I think that the right way to start thinking about this whole issue is to take a clean sheet of paper, mentally, and to look at the skill sets that a successful company needs to get hold of and combine together. Then let us look at what a good board does to manage its responsibilities properly. Until we get that picture properly in mind, we are in danger of being driven by the corporate governance agendas of other people who have got a particular axe to grind, not standing back and getting everything in perspective. So let us just start with some basics. Incidentally, a board needs to manage external relationships, and those with stakeholders and shareholders and employees too. I am not just talking about driving a business to be profitable. Let us just take a look and see what a successful business needs to do. Now, although this day is sponsored by the Management School of the University of Lancaster, you might well say: "I haven't actually come to hear a management talk about how to run a good business". And I'm going to ask you to hang in there for maybe two minutes, so that I can try to remind you of what you already know which is about the key "hooks", the things that if a business is not doing them, it will fail. I am not here to teach you how to run a business. But you need to remind yourself of those hooks, otherwise we will again get captured by other peoples' agendas.

The principal objective of a business, in my view, is to create shareholder value. And how do you measure that? You measure it by the generation of cash and profitability and the increase of share value.

As an aside, and as an accountant here, anybody can be a bookkeeper because, basically, what you do is to record what has happened. If you are a bookkeeper for a voyage or a farm venture, you notice how much you spent at the beginning, you notice

what you get at the end, and if the farm is the same farm at the beginning as at the end, you can then measure your profitability. And you can get it exactly right. However, the only time you can get it right is when you have finished the trading cycle. Accountancy grew out of the need to allocate the trading into years (usually - but you can of course allocate into months or weeks), so that you could see at a point in time where you were on this cycle. With the industrial revolution, the trading cycle moved from the crop or voyage or whatever to a much longer term. That is why accountancy grew - because we need to be able to allocate into years when transactions belong, and what the measure of value is at a particular point. The whole skill of accountancy is just about allocation and that is all there is to it - allocation on the basis of book keeping. The high pinnacle of accounting, therefore, is to get the profit measure in those years right, because any damned fool can get the cash measure right.

Accountants have elevated profit to a level which is much higher than cash, because it reflects their professional skill, which is to measure profit. It has only been in my lifetime that people woke up to the fact that, if you had a business like Rolls Royce trying to develop a new engine, you needed to monitor the cash as well as the profit. Now, accountancy has not gained the same ascendancy in the Far East as it has here, largely because accountancy works best when you have got a well-developed capital market. And, indeed, you will only find a strong accounting profession in the world when you've got a strong capital market. You will find no accounting profession in the communist block when you had no capital market; you would find lots of bookkeepers. And so in Asia, where the capital markets have not been so strong, there has been a much greater awareness of the importance of cash. Good for them! One thing that we have learned as a profession in recent years is that you do not just measure results by profit - you also measure it by cash!

A successful business understands its customers and anticipates change. Well, a business that does not do that is going to be obsolete shortly. It also understands where it stands in relation to others, just as we need to understand where corporate governance in the UK stands in relation to the world.

A company operates in two markets. I have just spoken about the fact that if there is not a capital market, there is probably no accounting profession. Anybody running a business needs to have their mind, like a schizophrenic, on two things: one is their product and services market, and the other is the capital market. They may be creating value in this one and losing it in that one, but they are two quite separate things to manage. They need to recognise this fact while running the business. This means a prioritisation of risks.

A successful business needs to understand that the key drivers in the past are seldom the key drivers of the future. What else does a successful business do? Well, I think it constantly seeks ways to improve and innovate; it recognises that customers like that, and it does not overlook the fact that it has got employees and stakeholders. Now that is a very quick, thumbnail sketch. Everybody in this room could add two or three points; that does not matter. Think of it as a butcher's room, with a whole set of hooks hanging in it; make sure that when we have finished looking at corporate governance, we have dealt with all those issues, because we might then have

reasonable corporate governance. If we do not, then we will have failed – we will have been captured by somebody else’s agenda.

So, then, we look at what a board does. Well, of course, the board makes sure that all those hooks are present. Does the board need to do anything else? Probably it does. It needs to encourage challenge and debate. All of you have probably had the experience of sitting in a board room where it is perfectly obvious that the chairman has decided what is going to happen, and everybody else is just nodding a thing through. The ability to tackle “sacred cows” is an implicit part of what a board has to do, and if you cannot do that, and you are on a board, then I suggest you get off the board!

I am involved with the IOD (as we as a firm are involved with the IOD) in an initiative for independent directors. We did a survey last year which shows that the thing that independent directors are most valued for is their ability to contribute to strategy setting. I actually feared that it would be the fact that they sat on audit committees, or remuneration committees, or things like that. That is not what they are valued for, and quite right too - they should be valued for adding value in strategy setting. Then there is the issue of risk management. Good companies have a language for risk management. It is not just: “did you meet your budget?”. It is not just about what new customers you have won. There is a language about risk in the company, and you can touch it and smell it; and if it is not there, do not invest!

I think that a good board focuses on management right through, and motivates and incentivises, and not just for itself - it plans for succession. How often do I see companies which do not plan for succession! Somehow or other, if you are in charge it is kind of threatening to your position to worry about people close behind you or around you who could do your job and would quite like to; you just want to get on with holding the reins. Actually planning for succession is really important, and a company that does not do that is not going to be healthy. Incidentally, the chief executive, in my experience, almost never does that: it is so rare. Who was the chap who left Rolls Royce, or Vickers? David Plaistow - he did. He actually had a plan; he planned for some time an orderly exit at the age of 59 or 60. Most folk do not, and the board’s job is to make sure that happens.

And then there is the need for this nice balance of strong leadership but not dominance. A successful board will ensure that conflicts of interest are identified and resolved; they are there, so flush them out and crack them. Communicate well with stakeholders: that is the last point. It is arguably the most important, but you cannot do that last point until you have done all the other bits first.

Now, again, a reminder. I am not telling you how to run a company. I am not telling you how to be a great board member – that is not the point of this morning. I am creating the “butcher’s hooks”, to make sure that you have got in your mind what good corporate governance consists of. If every one of those points is not being dealt with, then there is a weakness in corporate governance. And if you can think of any other hooks, fine. But that is where we should be starting to set our agenda.

Now, against that background let us look at the combined code and OECD code, and this is what I called the “Combined Combined Code” in my introduction. Directors’

duties have been considered: we looked at them. The Code's recommendations include the need for an effective board; and the need to split responsibilities to recognise that there are two tasks - running the board and running the company - and they are different tasks; the balance between executives and non-executives; the supply of information - if you have not got information, you can do nothing. And then there is the issue of appointments to the board, and re-election to the board. That is the essence of what is in the Combined Code. The OECD is nothing like as expansive as this. It is important to remember that we are ahead, in this country at the moment, of the international consensus on how boards should operate. The framework is there in the OECD, but it is not as well spelt out. We have got directors' remuneration very well developed, thanks to Greenbury and thanks to the political situation here over utilities. The level and make-up, the procedure and rationale, and the disclosure of the whole shebang - that is a hugely important area, and it would be the subject for a conference in itself. Accountability and audit I have taken next, although it is not the next in the Code. The need for balanced reporting: the need for transparency and disclosure, so that the reader can understand what is happening on all material matters; the need for internal control - not internal audit, necessarily, but internal control - that has been recently broadened, of course, beyond financial control to the whole of risk management. That is the Turnbull proposal, in the Turnbull Code. And then the role of the audit committee and auditors. I am just going quickly over these; you will be familiar with them, but I am just trying to remind you what the hooks are.

Then, importantly, relationships with the shareholders. Now this is interesting because we have got guidance in our codes, of course, outside the Combined Code here. We have got quite detailed Stock Exchange rules, and those detailed Stock Exchange rules have spoken to some things that we have touched on this morning about not oppressing minorities. I am using a legal phrase there, but that is the essence of them - fair treatment for all. That is not the case in most OECD countries, and so the OECD code has lots and lots on the fair treatment of shareholders. Fair capital structures, so you do not get too much bias towards the incumbent shareholders - "A" shares, "B" shares, and all those kinds of things. Shareholders being treated equally is the essential principle. And markets for corporate control; procedures to prevent unfair advantage being taken because you have better information than somebody else does. Procedures to prevent poison pills to protect bad management. Insider trading and abusive self-dealing should be prohibited. The issue of where you have got material interest and transactions - transparency. Incidentally - this is a philosophical point here, you may disagree with it - all of us loathe being manipulated, and the essence of good manipulation (if there is such a thing, and I do not think there is), if you are good at it, is that you do not get rumbled. So, if you are into psychology and Eric Berne's *Games people play* stuff, the whole essence of transparency is: "I can see what you are really up to!".

If you think in those terms and then take it across to companies, if there is something that is a bit difficult, disclosure is quite a powerful tool for improving practice. Just as if you say to somebody: "I really think you are not saying this for that motive - your real motive is something else", it changes the discussion. So disclosure changes the game in corporate reporting; it makes an improper motive much more easily spotted, and it also tends to improve the understanding of the market as to the true situation.

So disclosure is an incredibly powerful tool; just as it is in accounting, so it is in corporate governance.

The whole question of the way institutions interact with companies is intensely interesting and important, and we had two good sessions this morning touching on the issue of shareholder relationships with companies - a rich field, and the Combined Code is well ahead of the OECD in that. And then the whole question of relationships with stakeholders, as opposed to shareholders. You have got a session this afternoon looking at the responsibility towards stakeholders. That is undoubtedly where in the UK the debate had moved in the mid '90s. I think that Marks & Spencer's has done devastating damage to the stakeholder debate for the next few years, because it has proved a point that quite a few of us were saying, which is that your first objective must be to the shareholders, and within that you make your second objective to your stakeholders. If you lose sight of that, then you lose the game; I think the Bodyshop has had the same problem. That does not mean that I am anti-stakeholder reporting. I think stakeholding is the game you are playing in when your plain objective is for the shareholders.

Now, where does that all lead us, just to conclude? I think the first thing it does is to remind you that our time scale here is different from the international time scale. If we are going to make further moves in corporate governance, they are either driven by a local, political agenda or they are driven by making our companies better in the world game, whilst not giving ourselves a disadvantage in international capital markets. That is quite a difficult balance to strike, sometimes, because we do not want to be more regulated than is good for us. It needs to be demonstrably the case that the benefits are much greater than the costs of any new change. The second thing is that our focus is unquestionably now on performance, not on control; on the stakeholder issue - you will see more of that in the Companies Bill; and on the institutional shareholder relationship, between institutions and the company. That is where our focus is.

Internationally, it is different. The international focus is on protection for shareholders. It is not on institutional shareholders managing to push their companies harder; it is on making sure that shareholders are fairly treated, and that those who have large holdings are not put at a huge advantage. So the international focus is on shareholder rights, and it is still to come to address corporate risk. I think we are ahead on that score. So where does that all lead? Well, that is where we are at in the debate, and that is where I think you will see further progress being made. But, back to the very beginning. I said that there is no review clause in the Combined Code, so the changes that emerge will most likely come from legislation, not from a self-review process, and they will probably come in areas where companies and their shareholders find they can perform better by doing something so that it then gets disclosed. I do not see, in the area of corporate governance here, a major change coming which will give as much of an earth shift as we had with Cadbury, or as we have had since, with Greenbury and the Combined Code and with Turnbull. Thank you again. I am going to rest at that point. *[Applause]*

Panel of Morning Speakers: Questions and Discussion

Ken Peasnell: Thank you, Nigel, for that background on the Combined Code.

(To the audience) You have all sat very patiently through three, I hope you will agree very good, presentations. It is now your opportunity to ask some questions of all or any one of the members of the panel.

Sarah Wilson, Manifest Voting Agency: Nigel, if I can direct a question to you, it was a very interesting exposition on the role of the Combined Code. We have been monitoring now for nearly five years the growth of corporate governance here in the UK. One thing that concerns us is the proliferation of code-creating bodies. We have the OECD; we have the various stock exchanges; and we have the International Corporate Governance Network, the ICGN, who will be meeting in New York next month.

But, even though we have got these various good bodies all talking about the issue, when it comes down to practical implementation there seems to be a great gulf between what is said and what is done. I am thinking here particularly of the proposed merger between the London Stock Exchange and the Frankfurt Stock Exchange, where issues of transferability have been addressed immediately but issues of ownership have been left out almost entirely. We are now in an interesting situation where there could be arbitrage of corporate governance responsibilities between markets that have higher (or lower) disclosure and accountability and shareholder rights and proposals. Could you gaze a little into your crystal ball, Nigel, and give us an idea of what you think is required to crystallise some of the changes, so as to get more of the exchanges to accept a harmonised approach to corporate governance issues?

Nigel Macdonald: I think that is a super question. I think everybody heard it. I think it is not just for me to answer that, but it is for you to decide - and it seems to me that everybody here will have a comment to make.

I think the whole debate about the Euro here in Europe has been a little bit similar to the question you have asked: unless we take a look at the total picture, which you can say is both the whole governance issue as well as the market issue, we lose sight of the debate. We are not here for my view on this, but my own comment on this would be that what is happening in the Euro (amazingly quickly) is that the governance issues that were predicted here to be a problem have surfaced. They are perfectly fixable, but they were not addressed early enough - and there was this obsession with getting to a particular market, I think for promotional reasons. The same thing is happening with the London Stock Exchange and the Deutsche Borse. The focus there is that this is a market that will get away from us, so there is a focus on the market - it is not a focus on governance. You are completely right.

I think that the only way we are going to be able to get this solved, I regret to say, is by recognising that some exchange has to take ultimate authority. That, in my view, will be the US - and it will be the New York Stock Exchange. There is a frantic turf war going on in accounting, and in corporate governance, as to who can be the main influence, assuming that we are all working in a benevolent environment where the best argument will win. We are working in a ruthless bit of capitalism, and capital

markets are as ruthless as any part. Therefore, I do not think we will get this, what you might call, logic coming into corporate governance until we have ultimately one world-wide body controlling capital markets. At the moment we absolutely do not have that. I can just give you an illustration of that, and then I will pass the discussion back to Ken.

In this country, we introduced a thing called the Review Panel ten years ago, and I happened to sit on it; it actually is quite effective - but I would say that, wouldn't I? It has been quite effective in improving reporting standards for accounting. There is no international review panel: there is no mechanism at all for "enforcement" internationally - none at all. The SEC has a different mechanism. The SEC is terrifyingly powerful, so if you are listed in the States you have to play that particular game. But there is no mechanism of that sort - there is no review panel - internationally. There is actually a "zoo" out there, and your point is spot on. I do not think that the "zoo" will be resolved until we have ultimately some sort of world authority. And I guarantee every nation will fight to the death before it allows its sovereignty to go, because when that happens they feel they have given away half of the management of the economy.

Ken Peasnell: I wonder if I can just try and broaden that out to the other speakers by building on your own question, if you'll allow me. There is some empirical evidence to suggest that one of the motives why companies from code-law countries seek to be listed in New York and London is because of the protection that minority shareholders effectively buy into, by being listed in those countries as opposed to their own. That is re-stating your statement, if you like. The question is, "does that matter?". I mean you can have, as I think Colin (Mayer) said, competition between governance frameworks. What we have got here is two aspects of governance. You have got the question of mobilising capital (which is what we are witnessing here), but we have also got the other side of the coin which Colin alluded to, which is, in mobilising it, you may demobilise part of the company, by loosening the actual accountability. I will give you a chance to chip in on that Colin.

Colin Mayer: The question that you raise is, I think, an extremely interesting one. The Frankfurt-London Stock Exchange merger really brings the issue to the fore. I think there are two aspects to it that are important. First of all, one can think about it in terms of the governance of exchanges themselves, and the rules governing trading of securities in different markets. To what extent is it desirable necessarily to have harmonisation of those regulations? Now there is an activity for which the international trade in securities is clearly crucially important, and having a basic concept of rules under which participants engage in different markets is clearly of crucial importance. I think that one of the concerns that underlies your question is the absence of the emergence of such a common framework within the exchanges.

The second set of issues is the relationship between exchanges and companies. Again, the reason why the Frankfurt-London merger is so interesting, as I was indicating in terms of the differences in ownership and control of companies in Germany and the UK, is that the nature of firms listed in different markets and the nature of their governance arrangements are striking. That raises a question in terms of the governance arrangements of the companies that are listed in different exchanges: to

what extent does one have to harmonise those rules? Now, there are a number of different proposals on the table. Clearly the OECD framework is trying to lay down the concept that similar minimal principals should apply. There is the view that Ken has just expounded - that an important element in terms of getting good systems of governance imposed at corporate level is to allow companies to raise external finance. And there is evidence that a number of people are linking together the extent of investor protection rules with the amount of external finance and the growth of capital markets and access to finance by the company.

So, to that extent, having a strong set of rules like ensuring active outside investor participation is going to be a feature that companies themselves are going to want to be able to demonstrate. But for other companies, at some stages of development of some types of companies, the importance of active governance and having long-term participation by investors is of more importance than access to a broad capital market, and for those the nature of the control structure is rather different. One set of suggestions that is being debated is the notion that one might have a minimal set of rules that are common, but one then has a set of codes from which companies can choose and put together a basket of different terms under which they are going to operate. What is clearly crucial for the successful operation of that type of system is that investors and outside participants are aware of the particular set of codes that accompanies the particular activities, rather than there being the imposition of a uniform set of rules.

Mike Wright: I think that Colin put some of those things well. I think my concern is very much with what I call the “Macdonaldisation” of corporate governance that harmonisation may tend to. In my case, I am not a fan of Macdonald’s. I think this was brought home to me back in February. I’ve been doing quite a lot of work recently on corporate governance in Russia. I was at the OECD round table in February in Moscow, trying to apply the OECD principles of corporate governance to the Russian situation; this seemed to me to be trying to take it a bit too far. This is the “Wild East”, for God’s sake! So I think one has perhaps to have some broad principles, as Colin was suggesting. But I think you do need bio-diversity (to mix metaphors), between the kinds of approaches that may be appropriate in different circumstances. If one tries to harmonise too much, then I think there will be just a bland system that will not pick up on the idiosyncrasies of different corporate markets and different activities that we need to address and be aware of.

Ken Peasnell: Another question?

Michael Mumford: If there is an opportunity, I will jump in. Can I make a comment first. Colin Mayer made some comments earlier on which would have been very interesting indeed, I am sure, to the European Union. A number of you will have seen from the preliminary announcements of this conference that we had hoped to have Karel van Hulle, from DGXV of the European Commission, on the panel today. I am afraid that about a week ago, he got in touch with us and said that, unfortunately, the European Union Accounting and Advisory Forum had to be rearranged at very short notice, from Tuesday of this week to Monday of this week. So unfortunately Karel cannot be here. On the other hand, he will be getting a copy of the transcript of the

conference, so everything that we have to say he will no doubt read, and he will be able to reflect upon it.

What I wanted to ask the panel was a slightly different question, which is a particularly UK-orientated one. Given that such a large fraction of UK listed company shares are held by institutions, how do you make the institutions themselves answerable? I know that this is a thing that exercises Sir Adrian Cadbury; he is a visiting professor at Lancaster, and I have heard him say this a number of times. Is this a problem, or is it simply a question resolved by making the institutions publicly accountable, so that investors and policy-holders can choose which institution to go to?

Ken Peasnell: Mike (Wright) - you know and work with certain kinds of institutions which after all do take an interventional stance. I think what Michael is referring to is the broad brush picture of voting power. Is there any lesson from what we know from the buyout world that might be projected to the wider corporate sector, where we know there has been historically “a prisoner’s dilemma” or “free rider” problem, or whatever you want to call it? That means that individual investment managers do not necessarily want to intervene, if only because they may then have to go off market.

Mike Wright: I think it raises issues on the one hand of who monitors the monitors, because there are agency problems at a higher level. If you look at the venture capital market and the buy-out players, what we see is that the executives who do the monitoring of the investee companies are themselves remunerated by the performance of those companies – it is not just a salary arrangement. I think that helps to incentivise these people to monitor these companies in an appropriate way perhaps for accountability purposes, but it tries to maximise the shareholders’ wealth as well. Maybe we need to look in that area in terms of the way the institutional executives are monitored. I think that raises a separate problem in terms of the length of time period over which the monitoring occurs. If the executives in the financial institutions are monitored themselves on a very short term basis, then you may have a perspective that is not positive towards the performance side of corporate governance. Compare that with the venture capital world, where clearly you are locked into a situation for 2, 3, 4, 5 years, and as the executive you cannot get your remuneration through a gain until you are actually realise that gain. To look at the ways in which one could look at remuneration of institution investors, we need to try to get away from a short-termist approach to remuneration.

Colin Mayer: The question about institutional involvement obviously raises an antecedent question about how much there is. We do not have a great deal of evidence. There have been a number of studies of institutional involvement, and the institutions clearly claim that behind the scenes they do a great deal and that what one reads about in the newspapers is just the tip of the iceberg. The extent to which there really is active governance is something that is not entirely clear cut.

What we do know, though, is something about the way in which governance works in the UK. Now there are lots of aspects of governance, but one that I think people particularly have in mind is the extent to which, when there is a problem, the problem is corrected and how quickly that problem is dealt with. One bit of evidence on that is

intervention in terms of changing members of the board in poorly performing companies. What we observed is that in UK companies there is a high degree of board turnover in poorly performed companies, but really in only very poorly performing companies. So performance has to deteriorate to a point where, in the terms in which we were looking at, you were right in the bottom decile of performance of companies before there was an abnormally high level of boardroom intervention. And if one then talks to institutions about when do they in fact intervene, the response that comes back is that it is possible in principle to intervene, as I was saying earlier on, by forming coalitions of perhaps six or so shareholders - but it is actually quite difficult for them to do so. The one occasion on which they can effectively intervene is when a company gets into financial difficulties; so what one observes is a considerable amount of institutional activism associated with the provision of new finance. As one institution put it to us, it comes to a crunch when a company wants to raise finance to get itself out of difficulty. If you look at the data - and this was really quite surprising when we looked at it - we found that there was, unusually, a rather high level of distress rights issues. So, when companies get into difficulty, it is not unusual for them to come back to the market to raise new equity. Partly because of the rights requirement, that is an occasion on which an institution can essentially lay down a “conditionality” clause: “We will provide additional finance, but only if the management changes. The good news is you get the new money: the bad news is you will not be there to enjoy it!”. That is one of the reasons why, when one looks at the evidence, one finds that it tends to be concentrated very much in the very worst performing companies.

If you look at the United States, there is evidence that there is more intervention there prior to really poor performance, but, again, it does not seem to come very much from institutions – there is more in the way of active industrial, rather than active institutional, investment. So, in response to your question, I think that institutions are right when they say that they are not entirely passive, but the nature of the involvement that one would like to see is rather earlier than what seems actually to go on. Whether or not there is an easy way of changing it, so there is more general involvement, I have my quite serious doubts. It may well be the case that we should be looking to other types of investors to be performing that negative role - what Mike (Wright) was talking about in terms of shifting in and out of different types of ownership structures may well be the way forward.

Ken Peasnell: Thank you Colin. Nigel?

Nigel Macdonald: I think it is helpful to look at the issue of role and purpose, and then from that to look at the structural legal issues. It seems to me that the typical institution is managing money for the long term, for people who do not want to manage it themselves. They may be incompetent to manage to, and know it. They may be competent to manage it, and do not wish to do so. But they choose the best organisation to do the direct investment (or their pension fund trustees choose the best organisation to manage it) and they then leave them to get on with it. So we need to remind ourselves that the supervision of institutions comes from people who don't actually want to supervise it: they want to trust others to do so. There is a fundamental problem there.

Therefore it seems to me that the way that the institution is managed is a reflection of the interests of their stakeholders. Some will go for index funds, to play the market for the long-term. A few will be passive investors in a select number of investments they think are hot-shots. And some - but I don't know personally any people doing this - would be more in the role of venture capitalists. But then you confront trusteeship law, and the whole question of the extent to which intermediaries are balancing their portfolios. I think, therefore, that there is a deficit in the governance of institutions, for the reasons I have explained, and it is absolutely structural. It seems to me that when institutions do things that Colin has just referred to, and when a company is in trouble or there is a change of control, it is a different sort of crisis - but there is a kind of crisis. Any other sort of time that you get change in institutions themselves is when the institution has done so badly that it loses control of itself. That is a rather remote form of governance, both by institutions and companies and by stakeholders of institutions. Now that comment poses a problem, but it does not give an answer.

There is another issue, though, which I think is also part of the problem, and that is the way our law prevents an institution from being an active investor unless it has decided to become an insider. Now, Colin and Michael are well able to explain to you much more lucidly than I can how illiquid the market is, and how the market goes into free fall certainly when two institutions or three pull out of a company. The classic, I think, is the Fison's case a few years ago, when Fison's chairman was found out telling "porky pies". The shares went into complete free fall because no institution was a buyer, and the market was so illiquid that it just dropped more than half. That happens in shares quite often. So I think it is impossible for an institution to get out, because all it can do is to dilute its stake. As another issue, would it be better to allow institutions to become insiders as a force for good (assuming they would be a force for good)? It would mean they could become an insider without necessarily being caught with an inability to trade. Now when we were in Cadbury I floated this idea; it was in my mind for years, that you might be able to have the major institutions allowed to define what holding they were going to hold anyway, either by way of index or by way of recognising as real politics that it was pretty unlikely they would liquidate the holding. They would have to create some sort of Chinese wall internally, whereby they would have a group of folk who were actually managing those stakeholdings, and another group of folk managing at the margin to allow them to do this.

The institutions were not at all interested. The DTI was very interested in the idea: it was an attempt to get round what I see as a legal problem, which is that the institutions are either in there, playing the game, or they are caught by insider dealing so that they are not getting to manage their holdings. So I pose two issues, with no solutions - which is absolutely infuriating. One is the fact that, because the people who put money into institutions generally do not want to manage that money, we have a deficit of governance there. The second issue is a legal issue, which is that institutions are prevented, it seems to me, from being active investors unless they have made a conscious decision to stay with that business for the long term, which means for the whole of their holding. It would be in the interests, I believe, of us all if they were allowed to do that for a defined core holding which would be predefined, so there would be no gains there, and allow them to access the market outside their core holding.

Ken Peasnell: Mike.

Mike Wright: In relation to private buyouts, I think what we are seeing currently in the market is venture capital firms and LBO investors trawling through the FT 100 and below, looking for potential cases that are not quite in the distress situation that Colin was referring to, but companies where there is some under-performance going on. I think we are subject to these private firms talking to institutional shareholders, trying to get a feel for whether the institutional shareholders are dissatisfied with their holding, but perhaps have a problem with exiting. I think what this is leading to is a potential for public-to-private buyouts, involving some pretty large companies. I mentioned the United Biscuits case, and I think that we are going to see a lot more very significant public-to-private cases. This may be one way in which we can, perhaps, close the gap in governance. Rather than having to wait until Armageddon time, they can take action a little bit earlier, where institutional shareholders are going to be willing to sell to buy-out players. This is one way of bringing in more active investors, if we can't square the circle in terms of making the institutional investors more active.

Ken Peasnell: Could I ask a question, because it really follows on from the last two points. I get the impression, although it may be erroneous, that there are more Americans who act as "lead steer" investors – the Berkshire Hathaways and so on of this world. I do not get the impression that there is much of that in the UK. What impediments are there to that? Do you have any views on this?

Colin Mayer: Yes, the institutions certainly do say that, as Nigel was saying, the extent to which they can actively intervene is affected by the risks of them becoming insiders of particular companies. I think that the major issue that it raises is essentially a co-ordination question; it is a bit like the problem that we had at one stage in terms of bank involvement in rescues. Prior to the 1980s, there was serious concern about the extent to which there was a tendency for commercial banks to run away from companies that got into difficulties. The response of the Bank of England at that stage, at the beginning of the 1980s, was to play rather more of a lead role and set up the London Committee to try and co-ordinate them.

A similar issue, I think, arises in relation to interventions in companies: on the credit side, one normally has a lead institution - a lead bank - and that lead bank has a responsibility for co-ordinating activities where more active involvement is required. In terms of the UK and Eurobond markets, it is an issuing process; in terms of Germany and Japan, it is more active involvement in terms of subsequent involvement and corporate restructures. I think there is a question about whether one could get greater involvement by essentially establishing a similar provision for there being lead institutions for particular companies whose role it is to try and co-ordinate the activities of other institutions.

But what I think is perhaps a more significant difference between the UK and the US than Berkshire Hathaways and the others is the involvement of non-executive directors. Nigel was talking a lot about their important role, almost pushing towards suggesting a two-tier function. What one observes in the US is more active involvement by non-executive directors. It is still the case in the UK that non-

executives frequently perceive their role as essentially being to assist management rather than in performing a disciplinary function. And the fiduciary responsibilities of non-executive directors are more clearly specified, and more clearly implemented, in the United States than is the case in the UK. I think that the instrument by which not just institutional involvement but investor involvement in corporate activities could be strengthened is by strengthening that role of the non-executives.

Nigel Macdonald: Can I just comment two quick points. I think it is arguable there is a market failure in the field of analysts. If any of you have been in the role of finance director of a listed company, you will know that the game is to feed the information that you are not allowed to give to the analyst in a set of coding signals and remarks, so that the analyst's job is done for him by the company. It is a completely distorted form of communication. There is very little good analysis of companies - astonishingly little - with the result that companies actually control the information in the market place about themselves. At the moment, if you want to crack that then you do it for yourself; you do it as a venture capitalist, or you do it as an entrepreneur yourself: you don't do it as an analyst. But that is a complete failure, in my view. Very, very seldom do you see really perceptive analysis. Mostly, you see the company's line absorbed, and then one or two winging shots made about it. I think that is part of the reason that this situation exists.

Apropos US experience, because the US board is typically non-executive it is forced into the monitoring role that Colin describes, and that is a very good thing. Very seldom do I see amongst our clients in the States an executive US board. Instead, it is actually acting in the role of challenger because that is its role - whereas over here quite often the non-executives find themselves having to split themselves between being supporters and challengers.

Ken Peasnell: There is just time for one more question.

Steven Young, Lancaster University: I just really want to pick up on several other points that were made, and broaden the discussion somewhat. We know for a fact that there is a spectrum of governance arrangements. We talked about the international differences - some very large international differences. But what we observe empirically is that, no matter what system of governance you have in place, essentially governance seems to be reactive. It is driven by crisis.

What seems to me more the fundamental issue is how to take a particular governance system, no matter what it is - if it is a market-based system or a relational-based system - and make it pro-active; make it act in a timely manner, rather than simply to react to things when they have gone wrong. My question is whether reactive governance something that we must live with, or is there a way to make things more timely?

Colin Mayer: I think the issue as to whether or not any systems are more timely in terms of their intervention is an extremely interesting one. Some people would argue that we do have mechanisms; they are not the ones we have been talking about just now, but we have a very active market in corporate control in the UK - an unusually active market even by US standards. One of the features of companies that are subject

to hostile take-overs in the UK is that they are not poorly performing companies. The targets of hostile bids in the UK are very close to averagely performing companies. So one interpretation of governance in the UK is that intervention by institutions, and intervention by non-executive directors, is concentrated on the very poorly performing companies. There is another mechanism, which is the take-over market, which essentially is concerned with shifting performance, not from being right down at the bottom to being average performance, but of averagely performing companies to being above average.

Now I don't think that that is actually quite the right description of how the take-over market operates. I think that it has got much more to do with essentially changing the strategies of companies. It comes back to what I was talking about earlier on, and that is the potential advantage of the market biased system in terms of greater flexibility and being able to shift the strategies of companies relatively rapidly. But that I think is a very important aspect about governance; it is not the one that we normally focus on in terms of performance improvement, but clearly one of the aspects of good governance is to be able to respond to changing market conditions, to have incentives to implement long-term investments where that is desired, and also to be able to change direction rapidly when necessary. I think that is a function that the market biased system is able to perform.

Mike Wright: Venture capitalists and LBO associations do have a very pro-active corporate governance mechanism; mind you, the more we can do to promote that kind of wider applicability, the more that would make corporate governance pro-active. Something we have not really touched upon but I think is very important is that we need to understand more about the complementarity and substitutability of different facets of corporate governance systems, from the role towards directors right through to the role of the market for corporate control. The more we can see this complementarity, making sure that various mechanisms are in place to enhance corporate governance, then the more, I think, corporate governance will be less purely reactive and hopefully more pro-active. I think that is another area we need to look at.

Nigel Macdonald: Can I just add a comment. The Highway Code doesn't create good drivers, and the Combined Code won't create good corporate governance. We cannot expect codes to create pro-activity. (*To Steven Young*) You are absolutely spot-on: it is reactive, and we have to look to other market forces to reward and stimulate pro-activity. I don't think we will ever get a code that does that. We can help the market work through the disclosure requirement that says: "how did you handle this particular problem?". And then the company that has got a true story to tell that is good may get some advantage. I did see that there was an advantage to being a "good corporate governance company" rather than a "bad corporate governance company". You would have seen that survey about a year or so ago – it meant something like 10% or so lower cost of capital. I would be surprised if it was ever higher than that, because governance is only one part of the whole picture.

Ken Peasnell: I am conscious that one or two other people wanted to ask questions, but I am also conscious we have run out of time. We do have the rest of the day, so you can feed those questions into later sessions. It remains for me just to

thank the three speakers for their excellent presentations. I think they kicked the day off to a good start. [*Applause*]

[*LUNCH BREAK*]

Afternoon Proceedings

Steven Young: I shall be chairing this second session of the conference. The format is slightly different from this morning, in the sense that we are going to have two presentations followed by a discussion and a break, and then come back for the final session and a discussion following that. So we have two papers in the immediate session, the second of which will be from Sarah Wilson from the Manifest Voting Agency.

But first, I would like to introduce the Right Honourable Lord Newton, from the Institute of Directors, who is going to talk about corporate governance structures and wealth creation.

Corporate Governance Structures and Wealth Creation

Rt. Hon. Lord (Tony) Newton

Lord Newton: Well, thank you very much indeed Steve. May I say how glad we are at the Institute to have this opportunity to join with you at Lancaster University, and also with those here at the ACCA in these admirable premises, in discussion of these issues.

Obviously enough, the question of corporate governance specifically, and the relationship with wealth creation in general and broad terms, is necessarily a subject of much interest to the Institute of Directors (IOD), where for the past 18 months or so I have been Professional Standards Director.

I just want to say a word or two about the IOD, because there will be some of you of who will know quite a lot about it, and others who will know rather less about us and about our links with this field. The notes for this event describe it as the largest membership organisation in the UK for directors and business leaders. The

membership, I hope, will be of interest to you; it is certainly of interest to us, and perhaps a sign of the times in terms of the interest in these matters. Its membership has been really growing very fast over the last few years; it has increased by about a third, I think I'm right in saying, in not much more than about five years. We now have, in round terms, about 50,000 directors in membership in the United Kingdom itself, and several thousands more in overseas affiliates and connections of all kinds. And not the least of the points of interest, perhaps, about the IOD is the connections that it has around the world, which inter-relate with some of the references that I am sure have already been made today to the Commonwealth Association on Corporate Governance and the Commonwealth guidelines on these matters. We ourselves have quite close links with IOD South Africa, with IOD Zimbabwe, with IOD Nigeria, with IOD Australia, New Zealand, Canada and a number of others around the world, and we work with them in maintaining and developing the sort of interest which would have been touched on here.

Apart from that, of course, in the United Kingdom itself we provide for our members a variety of services, not least facilities in Pall Mall, but, increasingly, over the next few years, facilities around the country. We have just embarked on the development of a network of centres around the country in a private sector partnership with an organisation called 'Stonemartin'. So we will be doing more throughout the country to provide, if you like, a base and a meeting point for our members, and the opportunities for them to pursue their interest in directorial matters. One of the reasons, I think, that our membership has been growing so fast - and again it inter-relates with the subject matter today - is the growing awareness amongst many directors about the need for a better flow of information, advice and knowledge of current developments which are (or ought to be) affecting their boards, which leads to a significant demand for our, I think excellent, information and advice services. We shall be seeking to develop those later in the year, by developing IOD dot com. This was launched, as it were, in concept within the last month, and will be launched in practice later this year, as a reflection of the modern way of getting information, advice and all the rest of it to directors up and down the country.

Now all of that is a bit by and large, but alongside that we have got two other roles which bring us rather closer to the purpose of today's event. One is representing the interests and views of directors. Of course, directors, like anybody else, do not always have the same view on everything. But we do generally seek to represent the views of our membership. I should be surprised if there are many in the room, whoever else they know about in connection with the IOD, who have not seen the face on television of my colleague Ruth Lea, the Director of Policy, who articulates those views on very many occasions. My own role, and the role of the really quite small department which I head in the IOD, the Professional Development Department (of which Dr. Daniel Summerfield here is a very valued member), is concerned with these corporate governance issues - with the promotion of director education and development, and generally with promoting high standards of awareness amongst company directors in ways which I shall touch on later in my remarks. Interestingly, I myself also have a number of public sector connections - NHS Trust boards and that kind of thing. I am very conscious of the extent to which corporate governance, which has probably been focused on mainly here so far today (and will indeed be in my remarks) mainly in relation to the private business sector, also has an escalating importance attached to it

throughout the public sector. If you go to higher education, further education, the NHS, no doubt the small business service, certainly the existing TECs and Business Links, you will find strong emphasis, all the way from Whitehall downwards, on standards of corporate governance, applying much the same principles that have been discussed here today in the work of the private sector. And of course the same is true of another sector with which I have quite significant connections, namely the charitable and voluntary sector.

Wherever you go, into anything connected with the provision of goods and services of various kinds, whether it is in the public sector or the private sector, corporate governance is very high on the agenda. Now there is just one other thing that I want to say, having said all that about the IOD and since I intend to return a bit later on to some of the things that we are seeking to do that relate to the matters under discussion. I have not come here as a spokesman for the IOD. What you are hearing are my own views, informed by 18 months of experience at the IOD, not some great policy statement. I say this with particular emphasis because I would not want to be reported back by Professor Parkinson as having declared some formal IOD view on some of the more sensitive aspects of the company law review, which he will no doubt be touching on later.

Now, having said all that by way of, perhaps over-extended, preliminary remarks, let me just underline something that has already come through once or twice in the ways that this conference has developed today. I emphasise also that the approach in everything that I say, as is probably already by now clear, is going to be pragmatic rather than academic or theoretical. That is not, I say to Michael Mumford, an attack on the academic input into this area, which I think is important. But certainly in the Institute, and it is my own cast of mind as well, we are primarily concerned not about how we can erect great theories of corporate governance, but how we can play a part practically in improving corporate governance in businesses, not least small and medium businesses throughout the country. And let me just make a couple of observations in that spirit.

First of all, you have given me the rather grand title of 'Corporate Governance Structures and Wealth Creation'. I am not quite sure whether you are asking me to prove the link or to simply declare a belief in it. But one of the problems, it seems to me, for anybody who is approaching it - whether in a practical or in a more theoretical way - is that we seem to me to be here in an area where the link between good corporate governance and better wealth creation is, on the whole, assumed rather than proved or demonstrated. We would actually quite like to be doing more about this ourselves; we would like to enhance our research effort. There is a real need, and again I link with the academic world, for some actual research that will demonstrate, on the basis of observations no doubt over a period of time, the link more clearly than it is shown at present. That does not mean that I do not believe in it. I am persuaded, but it is as a matter of instinct, more than anything else, that the improvement of corporate governance will lead to the improved operation of enterprises, and therefore help to achieve the fundamental objective of improved wealth creation. And I am encouraged, even if I cannot demonstrate it any more than (as far as I know) anybody else can, by the fact that it is so widely believed.

I have already referred to the extent to which emphasis on corporate governance has spread across every sector in the United Kingdom. The other thing that has struck me, particularly in the 18 months or so that I have been involved here, is how all round the world - especially when things start to go wrong, or when there seems to be a lot of difficulty - it is to corporate governance, whether they use the phrase or not (and mostly they do), that people turn to find some kind of answer. Among my earlier experiences at the IOD was some contact with a Japanese organisation called the 'Japan Management Association', whose board reads like a list of all those Japanese company names that are in every consumer goods shop and motor show room in the country. Now, the reason that they were talking to us was that they wanted to introduce a version of our company direction programme and our Diploma in Company Direction in Japan. And that is exactly what they are now doing. And I know that there are considerable pressures in Malaysia. I am not so sure about Japan as I am about Malaysia, but a large part of the origin of the interest in corporate governance there was a conviction that their economic difficulties of two or three years ago were to a significant degree associated with deficiencies in corporate governance. So part of their answer to the problems was to turn to corporate governance and seek ways of improving that, in the case of the JMA in co-operation with the Institute of Directors here - which, of course, we took as a compliment and encouragement.

It is even more certainly true that a heavy emphasis has developed on corporate governance in all those areas where people are concerned to promote economic development from an under-developed base, within developing countries or from so different a base that it could be described as under-developed - in particular the ex-Soviet block countries. One country in eastern Europe after another has turned to other parts of western Europe, including this country, for advice on how to create a private sector and build in proper mechanisms for corporate governance to ensure the success of that sector.

I have already referred two or three times to the Commonwealth Association on Corporate Governance, and I think there has been reference to the Code. Again, improved corporate governance has been seen as one of the things that is necessary to ensuring improved economic development on a sound and secure basis. So, whatever scepticism there may be, and whatever uncertainty about the exact nature of the link between corporate governance and wealth creation, one thing is clear - that there is such a link is almost universally believed throughout the world and is now reflected in what everybody is doing. That is one observation.

I also want to refer to small and medium sized businesses. I do sometimes worry a bit - I don't know whether Michael Mumford or indeed Professor Parkinson have any sympathy with this view - that to a significant degree a lot of the argument proceeds at a level which must make it seem a bit remote to your average medium, let alone your average small, company. I mean, take the Combined Code. I know it does not apply to SMEs anyway; as we all know, and I know Nigel Macdonald will have spoken at length about it this morning, we are talking there about listed companies. There may also be implications for others, but those are the people to whom it principally applies, who probably see it as most relevant to their activities. Indeed, for a small or medium

business to talk of large numbers of non-executive directors and committees on this and that is really rather remote from its actual practical way of working.

It is remote when put in those terms; but, nevertheless, a lot of the principles and objectives of having these committees and setting these principles are just as relevant (and indeed, in some cases, may be even more relevant) to small and medium businesses - as I suspect quite a lot of the dot com companies are discovering at this very moment. This is an area that we in the IOD are already trying to pay some attention to, and I hope we will do more. I think, to be fair, that the company law review, with its declared emphasis on 'Think small first', is reflecting the same thought, but I do think that we need to give a bit more thought to translating some of these great ideas about corporate governance into terms which can actually be seen as relevant to, and have an impact on, the myriad of small and medium enterprises who make up, overwhelmingly, the bulk of the number of firms and of the employment base throughout the country.

There is a reflection of the same basic point in those Commonwealth guidelines - the need to relate guidance to the actual circumstances of the people you are dealing with, who are often not great companies of the kind that are relatively familiar with the Combined Code. This is one reason why the Commonwealth felt that it was right to have Commonwealth guidelines specifically related to the needs largely of developing countries. They thought that a lot of what was in the OECD guidelines was not really very helpful from their point of view, simply because it reflects the circumstances of firms in the large, developed countries but would have relatively little relevance to the situation actually on the ground, shall we say in Nigeria or Zimbabwe or any of the other countries where importance is attached now to corporate governance.

The other thing that concerns me about the debate on corporate governance - less so now that it would have done two or three years ago, I think - is the extent to which it has continued to reflect its defensive start. Now, I can well understand its defensive start. As it happens, I was Secretary of State for Social Security at the time that the Maxwell pensions scandal broke. Even now, I can remember the difficult interview I had on Channel 4 News that evening, when all we knew was that something pretty substantial had hit us, but we didn't quite know what. There were obviously very large questions which had to be addressed to sort something out. So I understand, if you like, the defensive beginnings of much of the corporate governance debate in its current form, that is to say in the form that underlay the Cadbury and Greenbury Reports. It was very much on ensuring that governance procedures were adequate on the financial aspects and on executive remuneration - if you like, the sort of policing level of corporate governance. Now that emphasis, as I am sure has been acknowledged today, did shift quite a bit with the appearance of the Hampel Report in 1998. As they commented: "accountability is vital to the success of the business, but the emphasis has tended to obscure the board's first responsibility, to enhance the prosperity of the business over time". This, I need hardly say, very much reflects the view of the IOD.

There is an imbalance, if you like, between good corporate governance seen as an aid to better policing of companies and good corporate governance seen as an aid to better business performance - perhaps that would be the way to put it. I think we have still

got some way to go before the emphasis is redressed as much as I would like, to get the right balance between the accountability issues and the promotion of wealth creation. I hope that the re-balancing will continue. It is a slight concern that it has been reinforced by something else that I would be surprised if it hadn't come up today: the Turnbull Report on risk assessment and risk management and all that. Quite a lot of people have reacted by placing a lot of emphasis on avoiding risk, against a background where actually you cannot. I know this is totally against what Nigel Turnbull himself wishes and preaches when he speaks on the subject, as I've heard him do a couple of times. A lot of his emphasis has been on how companies are not in business to avoid risk - they are in the business of taking calculated, measured risks, if you like, and trying to turn risks into opportunities. I know he is concerned about the extent to which the reaction has been a defensive one: "we have got to set up new committees or structures to try to avoid anything difficult or unpleasant happening!". Whereas he would like to see much more of the emphasis on identifying the risks, so as to identify the opportunities and then take the opportunities. In other words, he would say that risk is the other side of opportunity, and it is on the opportunity as least as much as the risk that he wishes to see the emphasis laid. So, again, I think there is a bit of re-balancing that is required.

When it comes to putting some of these observations into the context of the company law review, I see that what I have written in front of me is the word 'cautious'. This is what I am going to be, as far as the company law review is concerned. Professor Parkinson is on the Steering Group, which is the body that is doing what I might loosely call "the real work", along with the fully employed team itself. I am on something called the "Consultative Committee", which is presented with the thoughts and views of Professor Parkinson and his colleagues and is then supposed to produce comments, and, in due course, comments on behalf of the organisations from which we come. Well, we are still in the process of doing that at the IOD, so I am going to be cautious today.

But I do think it is very welcome that the general flavour of the company law review – as well as the 'Think small first' declared emphasis, to which I have already referred - is much more than might have been anticipated in some quarters on the successful enterprise and wealth creation drive of it, and not just on increasing new rules and regulations of various kinds. But the declared emphasis at the outset of the document is very much on the link between company law, its association with corporate governance and the desirability of achieving economic success. And much of the argument is in the area of how far directors and boards of companies should be under pressure to take account of so-called 'stakeholder interests'. I am sure Sarah (Wilson) will refer to this at some length. I will only say - and I think I virtually can say this on behalf of the IOD - that one aspect we welcomed – although we are still doing some careful thinking about the way in which the review proposes it to be done - is the notion of clarifying directors' duties in some of these respects. This is not unwelcome to us, because it is very clear from our own work, including some modest research amongst our own members, that quite a lot of directors are less than clear about what their powers and duties are. I therefore see advantage in some clarification, particularly when it comes to taking account of (not "being accountable to" - an important difference) groups other than the shareholders, and of looking at the long-term interests of the company and its shareholders, rather than simply the short-term

interests. Therefore, in principle at least, a clarification of directors' duties that the company law review is seeking to bring about, following in part the earlier report of the law commission, is welcome to us, even though there may be points in the fine print on which we will want to make some observations.

One of the things we welcome clarification about, and I think most directors will, is that, in looking to the long-term interests of the company and its shareholders, it is not only permissible but normally sensible to take account of a whole range of other interests. The notion that a company is likely to flourish in the long-term without taking any interest in its employees, its customers, the community in which it is operating, is not one, I think, that most boards of directors would wish to advance. And clarifying some of those issues seems to me to be moving in the right direction. Before I move on, let me just underline what I sought to say in the last few minutes, by referring to one of our publications. It was one that was sponsored by the DofEE and the DTI, and it is currently being reprinted by the South African Institute of Directors, in a 'South Africanised' version, for use in their country. This is a document called *Standards for the Board*, which seeks to set out a lot of the things that have been talked about today in a form which is useful, perhaps particularly, to the directors of small and medium companies. This makes it clear that it is the IOD's belief that the purpose of companies is to maximise the efficient creation of wealth, while observing the law and seeking to minimise the negative impact of corporate activity on participants in society general. Obviously, corporate governance is part of the means by which this aim is achieved.

I indicated right at the beginning of my remarks that I would seek not to be too academic, but that I would concentrate on practical things. That is exactly what the IOD itself has been doing. I just want to bring my remarks to an end by making reference to two or three of the things that we are doing which may be of some interest at least to some of you. As an Institute, we are seeking to promote the practical side of all this, to acknowledge some of the codes and some of the wider discussions so that they get translated into the practical working of practical businesses. The background of course is that, long before my time, the IOD has been developing as the UK's leading supplier of training and direction programmes specifically for directors. There are tons and tons of courses for managers, and some of them will be relevant to directors; but I think that the IOD, to all intents and purposes, is the only body that runs such courses specifically for directors as such - and quite a lot of courses - in various parts of the country. We teach our company direction programme, or it is taught (under franchise mostly), not only in London by us, but in Belfast, Birmingham, Bristol, Dublin, Durham, Edinburgh, Leeds, Loughborough, and Salford. Over 4,000 directors have now attended our programme, so we have got a practical working programme to help develop directors. I know that 4,000 is not large in terms of the totality of company directors, but it is an indication of the way we would like to see things go. And that in turn has been developed over the years from just being a case where you can say: "well, I've been along to a course", to quite a demanding multiple-choice examination, on which is based a Diploma.

Then, more recently, we have gone into something I hope that some at least of you will have heard a little about - our Chartered Director Initiative. I will not go over that

at great length. It is beginning to build up at the moment, although it is still early days. What we are seeking to do there is what we describe as - and what indeed is - the world's first professional qualification for company directors, for which of course we needed Privy Council approval as a chartered body introducing a chartered qualification and status. It was approved by the Privy Council, we launched it last year, and we hope to designate the first Chartered Directors within the next month or so. This is a means of underlining and developing still further our response to the need that we perceive, to set and promote good boardroom standards and generally to foster a professional approach to the running of companies. The criteria are pretty rigorous; that is one reason why we are expecting it to build up at a steady, rather than a dramatic, pace. It involves usually taking the course. You do not have to take the course, but it would normally involve people in taking the course to which I have referred, which is a 15 day thing - not just something you can do on the basis of a one day conference. Passing the examination is not that easy; the success rate is around about 70% on the exam itself so far.

Then it is necessary to demonstrate that you have got the requisite amount of experience, in most cases three years' boardroom experience, in a "proper board" as it were. That is tested in an extensive 1½ hour interview by peers, by other directors with themselves quite substantial experience. And then, of course, if you pass through all that, you are required to subscribe to a professional code of conduct and make a commitment to continuing professional development. That, too, is part of the requirement; you cannot just do the course, pass the exam, show the experience, and become a Chartered Director. The point is that you, like almost any other professional in this country, now have to demonstrate not just that you have the knowledge and the experience at one particular point in time, but that you are keeping it up to date, and your capacity to continue to contribute in the boardroom is therefore being maintained.

Now, lastly, something that links me with one of your earlier speakers this morning, namely Nigel Macdonald at Ernst & Young. I will not outline the background, but both of us saw a need at the same time, and we have actually in the last few months developed between us something called the 'Independent Director Initiative', 'independent' being the term that we use in this context for what are more normally described as non-executive directors. Independence itself, of course, is a subject of argument. But I think that there is a need for more thought and certainly more underpinning of that role - more thought in the sense that most of the emphasis has been on the policeman role, for example of non-executive directors as members of the remuneration committee, the nominations committee, the audit committee, and no doubt now the risk management committee. We did some research for this Independent Director Initiative. In practice, it is clear that most companies put most of the weight in what they want from independent directors on their strategic input, their knowledge and their experience, and not just being the people who do box ticking to ensure that all the corporate governance structures are in order. The purpose of the initiative, and it is something which we in the IOD are putting a great deal of effort into, is to try and underpin the role of the non-executive directors. This has grown steadily, but it seems to us that the support mechanisms have not grown in parallel. We are seeking to do something about that.

I will just very briefly list some of the points which seem to me to emerge from what I have been seeking to say in the last half hour or so, and which I hope will tie in with other things that have been said in the course of the day. First of all, it is clear that most successful organisations and institutional investors believe that improved corporate governance structures lead to increased shareholder value; that is true not just here but throughout the world. The emphasis has changed, but in my judgement it needs to change further from just developing corporate governance processes and structures - the box-ticking approach, if you like - to putting more emphasis on increased shareholder value and promoting the success of the enterprise. We do need, I think, to develop a new sense of professionalism. That is one of the things that we are seeking to do in the IOD, as I hope I have indicated, for example in the role of corporate governance in the operation of company boards. But we must be careful to avoid the 'one-size-fits-all' approach, whether it is in relation to drawing lessons from this country to apply to others, or drawing lessons from large companies to seek to apply to small and medium companies. I think this is a danger that the Company Law Revue is clearly determined to avoid. Lastly, as I hope it is clear from everything I have said (and indeed from the very fact that two of us from the IOD are here today), we are ourselves very committed to improved corporate governance structures through our various professional development activities which see to balance integrity with enterprise. Thank you very much indeed. [*Applause*]

Steven Young: Thank you. It gives me great pleasure to introduce our next speaker for this session, who is Sarah Wilson from the Manifest Voting Agency. She will be talking about reforming shareholder relations.

Reforming shareholder relations

Sarah Wilson, Manifest, Witham, Essex

Sarah Wilson: Steve originally asked me to come and talk to you today about the reform of the shareholders' role in the corporate governance process. Why is Manifest qualified to talk about this? Some of you may not have heard of Manifest at all, and some of you may have heard some things about us but do not know what our role is. I will spend a few minutes on what we do and why we are qualified to talk here today. We are a facilitator in the corporate governance process. We enable institutional investors to vote all their shares in their portfolios on every single issue in every AGM, class meeting, EGM and court meeting, irrespective of whether the issues are contentious or not contentious. We have been doing this for nearly five years now, and we were the market leader in computerising the proxy voting process so that institutions do not have to be surrounded by masses of paper. Our motto is that voting is a right and that informed voting is an asset. And we believe that assets should be properly managed, and we are not advocates of box-ticking as has been mentioned earlier today. We want to get as far away from box-ticking as we possibly can.

That said, there is a very important role in computers actually delivering up packages of information to institutions who otherwise would claim they are too busy to take a look at the issues. I have to say I have been very disappointed, by and large, with the institutional response to the reforms of Cadbury, Greenbury and latterly Hampel and

the Combined Code. When compared with, say, institutional activity in the United States, we are absolutely years behind, and I think that we may stay years behind if we stay with a codified approach to corporate governance, which really has been reflected in the way that corporate governance has been introduced on to the landscape in the UK over the last five to six years. Let me just explain what I mean by that. We have codes of the “great and the good”, and we have institutions who now rely on those codes to do their work for them. Whereas, in the United States there is a complete absence of codified corporate governance - it is left to the open market to define what is good for corporate governance and what is bad for corporate governance, and institutions take their responsibilities as owners incredibly seriously. It is also backed up of course by the ERISA legislation (*Employee Retirement Income Security Act, introduced by the US Federal government in 1974*), which mandates that pension funds should vote their shares and give an explanation as to why they vote their shares. We do not have an equivalent of ERISA here in the United Kingdom.

So let me move on now to something which I think is going to have a major impact on the way that shareholders relate to companies. Nothing else would do but the green eye of the little yellow god. The little yellow god, of course, means money, gold, or returns. And the “green eye” to us is now the environmental aspect of investment which is coming to the forefront. I want to challenge the supposition that profits are going to be sacrificed on the altar of socially responsible investment (SRI) or stakeholding. You may not like what I have to say, but I really don’t care because I want you to go away thinking about what I’ve said. And if you go away thinking strongly either for it or against it, I will have achieved my objective here today, which is to take a different look at the way corporate governance and institutions interact with one another.

What is going to happen in July could, I think, be far more important than the Cadbury Report, as far as the institutional investors are concerned. I refer to a little line that has been slipped into the Pensions Act and its equivalent in the DETR (that is, the Department of Environment, Transport & the Regions). We have pension schemes in the UK, and we have superannuation schemes. Until very recently, they were run under completely separate legislation, but the government is doing this thing now called ‘Joined Up Government’, where departments actually speak to one another. Anyway, we now have a rule which says that pension funds and superannuation schemes must disclose the extent to which social, environmental or ethical considerations are taken into account in the selection, retention, and realisation of investments. There is also a little bit about voting policies as well, but I think this is the more important catalyst.

The reason that this was slipped into the legislation was to clarify the confusion that arose in some peoples’ minds about whether or not they could take these factors into account when owning or deciding not to own shares. The Megarry Judgement still stands. Megarry says that in a trust situation you cannot use your shares for purposes other than creating financial returns for the beneficiaries. Society, business and investment are inextricably linked; there is no way we can get away from it. Tony (Newton) actually alluded to it earlier when talking about the role of the Institute (of Directors) in promoting better director performance in companies. So, therefore, SRI is not new. Stephen Timms, who has the same position that Tony did in the DSS,

actually gave a great dissertation on what he felt were the biblical leads that you could find about socially responsible investment through John Wesley's "Sermon on the Mount", which proclaims that we should all gain all that we can. In other words, we should all achieve our financial goals as much as possible.

But the role of pension schemes and the role of companies are actually surprisingly similar. For their employees, the company has to achieve its financial goals in order for those employees actually to have jobs for now and for the future. And for their customers it's important for them to achieve their financial goals now and for the future so that the product and services are there. The pension scheme's role is to improve the quality of life of its pensioners, now and for the future. And there are many pension schemes that now feel that they can do that best by encouraging positive corporate behaviour, so that the companies that are here today are going to be there in 10 years' time, in 15 years, in 20 years' time. And I don't think that these desires and wishes from the SRI community are really any different to what the IOD is trying to achieve, and what the company law reform body is trying to achieve. We need profitable and successful businesses for the whole economy.

A shareholder's primary reward is profits; there can be no getting away from that. But a company doesn't exist solely to serve its shareholders. A company usually exists first of all to serve its customers, and it goes to shareholders in order to find the capital so that it can service its customers. So if a company's role is to enhance the profits for its shareholders, any policy which has an impact on generating profits is also likely to have social impacts as well, because, as we've discussed earlier, they are all inextricably linked. So social policies can have a very clear economic impact.

Before going on, I thought we'd do a little bit of history, because there are some of us here young enough not to remember some of these things when they came around the first time, things which are actually very important in the way that SRI has developed. I am not saying that SRI started in the 1960s, but I think that was when we had mass communication beginning, so that more and more people were actually aware of the issues. We see that civil rights, women's rights, the Cold War and the arms trade all began to leak out of the universities, as it were, and into the common stream of consciousness. Within the '70s and the '80s, we saw that there were management and labour rights disputes, we had the anti-nuclear lobby, and we had apartheid issues. And, into the '90s, we have ecology, ozone depletion, and global warming - issues which have all begun to impact on peoples' thinking about how they want businesses to behave.

But this poses dilemmas. It poses dilemmas for companies, and it poses dilemmas for pension schemes themselves. How are each of them to achieve long-term and meaningful goals without upsetting one another? And can a pension scheme, or a company for that matter, make any kind of difference through having a policy statement alone? Yvonne Stevens, who is our research manager, is here; between us, we must have read thousands and thousands of very bland and meaningless corporate governance statements which have come out from leading companies in the UK, which have paid lip service to the concepts of corporate governance but actually don't mean anything when it comes to the practical implementation throughout their whole business. So can it make a difference to have a policy statement alone? And what is

the cost/benefit trade-off, because no company and no pension scheme is going to want to set up highly complex schemes, committee structures and so forth if there isn't going to be a benefit for the cost of the investment.

Social investors are important in corporate governance development because they typically deploy three strategies which have two specific objectives, I think. We can all relate to them. The one is to make money. Every social investor I know actually wants to make money. I'm not talking here about charity funds; I'll leave those on one side for a moment, because within their charity structure they will have different objectives. But social investors, particularly in the pension market which reflects 60% or thereabouts of all UK quoted shares, make money and make a difference. They want the companies that they invest in to be the best possible companies that they can be, without infringing other peoples' rights, and without creating products which are damaging or which are not sustainable. They do this in a number of ways.

The first way, typically - and the best understood way - is through screening. That can be negative screening, or it can be positive screening. Negative screening is about getting rid of the stocks in your portfolio of companies which actually get involved in activities which you might not approve of. That could mean, for example, excluding tobacco stocks, and excluding mining stocks because, for example, the mining companies have poor human rights records. Positive screening, on the other hand, is about finding stocks which you think are going to take advantage of ecological or environmental or social opportunities which now are presented to us.

The other way that social investors make a difference is through advocacy. Advocacy is another word for activism. But activism in the UK here has a very poor track record. It is ill understood; it is seen as meddling and interfering, whereas to us advocacy is the most important part of corporate governance, because it is about dialogue between all of the interested parties. It is about people having mutual understanding of everybody's objectives and finding a common way forward. The other strategy (which I'm not going to talk about) is the role of venture capital - community investment. Typically, pension funds in the UK only invest around 5 to 10% of their funds in venture capital. But this community investment is often seen as one of the most important ways of getting socially responsible investment onto the landscape.

Now, of course, all fund managers screen stocks; they screen stocks on a quantitative basis and on a qualitative basis. Quantitative on the basis that they are looking for companies that have rising earning investments, for example - who, unlike Marks & Spencer's, are not going to have their dividends cut. The other is qualitative. I say to fellow managers: "well, can you define to me what qualitative screening is all about?". And they say: "oh, it is about quality of management". Well, that is a very nebulous thing. Quality, if you are going to take a really strict definition of course, means fit for the purpose. But quality can mean everything to everybody; there is no single agreed definition of what it should be.

So what should quality of management be? Here is just a quick check list of some of the issues that we think are becoming important in quality of management for the next 10 to 15 years. First of all, it is about leadership. Leadership is sustainable business

practices; that is a very loose term, because sustainable business practice could be about having the box-ticking approach to corporate governance that the Combined Code and Cadbury and Greenbury all had, because it is about creating a positive perspective on your company in the eyes of the market. If you are going to talk about your products in the terms that one noted jeweller did about them not really being worth very much, and lasting about as long as a certain under-performing clothier's prawn sandwiches, you find you don't have a job - you don't have a market place. That is not sustainable leadership by any stretch of the imagination.

Quality of management is also about relationships with employees, suppliers, and partners, because without any of those a business usually doesn't have a business for very long. It is possibly about ecologically superior goods and services. It is probably also about sustainable product development. We all know oil is going to run out; gas will run out; minerals will run out. So any far thinking company is going to be saying to itself: "what will we do when our basic raw materials run out?". It is about resource and liability management - and Tony touched on risk. Yes, a company's role is to challenge risk, and to see what its risks are and to manage those risks. So that's about resources, and liability management as well. It is about also deploying appropriate technology. I've called it resource technology. It is looking at ways of developing technology to address renewable energy, for example.

So that addresses the company's responsibilities. What about shareholders responsibilities? To me, corporate governance is about a balance, and I think it has been very heavily weighted towards companies over the last 10 years. It is all about companies spending money; it is about companies investing in systems and procedures. But we really have not had a counter balance from the institutional investors and from shareholder advocacy. I think it is time that the balance tipped a little bit more towards shareholder advocacy, and more people taking "ownership of ownership". It tends to be a very vocal minority of shareholders who are interested in being advocates, in a traditional sense of voting shares and showing management that they are watching.

We are really quite different from the United States, where advocacy comes before box-ticking - where advocacy comes before rules and regulations, and shareholders have a very tense relationship, as in "creative tension". Companies will expect to have shareholder resolutions put up to them. There were 300 shareholder resolutions at the last count in the United States. In the UK, there were three! That is a big difference, and you have to ask yourself why. There is no relationship between the numbers of shares that are listed in the New York Stock Exchange and the number of shareholder resolutions. If you say that there are 3,000 companies with shares quoted in the States and, say, 1200 actively trading over here, the balance is disproportionate, and you have to ask yourself why. It could be the mentality of the people in those markets: the way that they view their rights. Or maybe they see that they own those businesses, and that those businesses should be serving shareholders' needs better. So that was a very quick summary there, of screening and advocacy.

But I think it is now time to move the debate forward; it is time to move it away from rules and regulations. It is not about people doing good things and feeling that they've done good things, either in a SRI context or a corporate governance context. It needs

to be moved forward into part of every day - an inclusive approach to corporate governance and social policies within management. We often find that institutional investors have traditionally put corporate governance in a little box in the corner. They wheel it out once a year, typically around AGM time, and then they wonder why they can't do it because there is so much to do in such a short space of time. Whereas, once it becomes part of the day to day dialogue between the analyst and their companies, it becomes much more fruitful for them to have an active approach to shareholder advocacy. So making it part of the everyday relations means that you are not managing it by exception.

Now, let us focus a little bit about performance, because corporate governance - or the emphasis on corporate governance - came about because we wanted companies to perform. We often say: "what is the missing link?". Tony says he knows in his gut that there is a link between corporate governance and company performance, and there is also more than a gut feeling now on social performance and financial performance. The problem is that measurement is not very easy, because the whole area is not terribly well defined. It is very subjective, and there are different ways of measuring. I think that in the academic field we see a lot of interesting developments coming out on how we should measure successful companies and corporate governance structures. But we've had this thrown at us a number of times: "well, if you can prove to me that corporate governance is going to make my share portfolio out-perform by 15%, then I will vote my shares". And I have to say to them: "well, hang on; how about down-side risk protection? Surely it is as important not to have the five stocks in your portfolio that are going to drag the performance of your portfolio down?". But they don't see it that way. Fund managers have a different mind-set; they are looking for what is going to make the thing perform better.

So I hope to see much more research coming out of your organisations on where there are positive links. But I want to ask the question in a different way. I want to say: "what is the link between stewardship and social performance?", because we haven't heard the word 'stewardship' mentioned really at all in today's debate. I don't hear it talked about much in the corporate governance debate at all, because directors are stewards of assets. We heard that the company is not a natural being; it is a collection of assets. And the directors must look after those assets, not just for shareholders today and employees today but also for the future.

So good stewardship, again, is about that quality of management; we keep coming back to quality of management. It is a reputation for being soundly run. It is also a multi-factor model, I think, which actually generates superior performance. There is no one thing I think that you can actually focus on and say: "that's the thing that makes the difference in that company". It could be product lines; it is about planning and control; it is about quality assurance, customer service skills, and progressive personnel policies. Employee "churn" (*i.e. turnover*) is a major cost to British industry, and, as our population gets older and there are fewer young people to fill jobs, companies are going to have to have more progressive personnel policies in order for them to retain those expensive intellectual assets that they have. I think it is also about the ability to adapt. It is not like the days of the '20s and '30s, when everybody thought things would just carry on as they were. Business has changed

minute by minute and companies need to adapt almost minute by minute; again, it is down to the role of the directors to set the framework.

So I think we can reduce these ideas to a very simple sentence. The quality of management is about the capabilities, competencies and ability of a firm to marshal its assets to produce superior financial performance and achieve competitive advantage. Now, it is a shame that more of the Far Eastern companies didn't take this on board. Tony (Newton) talked about the role of corporate governance in the Far East. The Far East was riddled with cronyism. It was riddled with inward-looking management that wasn't aware of the wider issues of running its business. Possibly there was not enough quality management of the board, although there had been quality management of the product.

Skipping very quickly, then, what are the assets that a company should be looking after? Well, I think there are three types. There are the tangible assets: financial reserves, physical resources, plant and equipment, raw materials. There are the intangibles: technology, the company's reputation, its political acumen, the ability of the company to actually frame the regulatory environment of the future that it can work within. And there are the staff based human resources; that does include the training, the expertise that is locked up in those assets that wear shoes that go home every night. And it is about employee commitment and employee loyalty as well.

A manager's role is to turn assets into profits: I don't think anybody could argue with that. So, being corporately socially responsible is a corporate resource; it is an asset to be used or abused, and a director's role is to protect and enhance the value of resources. But that does require oversight - very careful oversight and supportive actions. Assets, therefore, need a catalyst. What is that catalyst? We believe that good corporate governance is that catalyst. How do we prove that? Well, I am pleased to say that there are strong quantitative links between quality of management, the treatment of owners (generally measured as long-term financial performance), good employee relations and good product quality. And, yes, companies are there to create shareholder wealth; it is very important, but on its own it is not enough to develop a reputation for strong management performance. Arguably, Richard Greenbury was a very strong manager, but did Marks and Spencer's treat their employees as well as they should? Did they treat their customers as well as they should? Did they treat their suppliers and their partners as well as they could?

Company reputation is what can drive a share price through the floor or through the ceiling, and company reputation for performance is generally proved to be more favourable when management practices actually result in better treatment not only of owners but also, again, of employee relations and good product and customer relations. So good governance is about creating good reputation. Many of these discussions are well rehearsed; they have been around for quite some time. Back in 1994, *The Economist* argued that society is moving forward to where corporate image is going to be the basis on which most of us make buying or selling decisions. So stockholders have an absolutely pivotal role to play in moving a business towards sustainable best practice - I think more so than what a shareholder might say in a one on one analyst meeting. If a company is really awake, it will pay attention to what its customers are looking for, and to what its employees are looking for. I think

environmental concern is going to be an even greater catalyst towards getting companies to move forward and change the way that they do business. It has been described as the biggest opportunity for enterprise and invention that the industrial world has ever seen.

There are two ways that companies can respond to that. They can stick their head in the ground; they can be resistant management, they can ignore it, they can contest the change and they could risk profound loss of productive energy - and that is a bottom line loss. Or they can recognise the possibilities, take the action, and assemble the resources; basically, don't ignore it - grasp it! It is one of those risk issues we were talking about earlier. Management policy, and a reputation for that policy, is a market advantage.

In 1991 McKinsey did a study of about 640 management leaders in the United States, and they came to the conclusion that organisations with poor environmental records will find it difficult to recruit and retain high calibre staff. I think it is possibly the case now that there must be a lot of employees working for the likes of Marks & Spencer's or Reebok who are going to feel a little disenchanted with their management's response to some of the issues that have faced them over the last two years. Do you want to work for a company that is known for oppressing its workers in the Third World and making young children work when they should be playing? Do you want to work for a company which spills cyanide into the Danube, for example?

I think these are much more emotive issues than whether or not you have a combined chairman and chief executive, and they can have a much bigger PR impact than, say, the composition of the audit committee, important though that is. Reputation for leadership in certain sectors, for example on environmental issues, will increase sales amongst customers who are sensitive to those issues. And of course we have generations of children that are being brought up with these messages thrust at them every day. The morality of businesses has become a far more important factor, I think, than many people give it credit for. The environment is also more important than just straight-forward box-ticking because it is, I think, much more systemic than anything else. It reaches from the very top of a company right to the person who is sweeping up the bits and pieces off the factory floor. Corporate governance, of the Hampel mode, or of the Cadbury and the Greenbury mode, affects just the top tier - it does not go all the way down the organisation, whereas environmental and social issues really are "bottom-up" and "top-down" and are more holistic in that regard. Again, there is a lot of work in the States looking at these issues at the moment, but it is very clear that companies who are lagging in environmental performance suffer at the hands of their stakeholders, particularly consumers and employees.

Pro-active management is an issue that was reflected in the earlier discussion today. It was in fact Steve (Young) who said: "why are we so reactive in corporate governance; why aren't we more pro-active in corporate governance?". When it comes down to products, and the environmental implications of products, I think companies will respond far more quickly than if they are merely told: "here is a set of regulatory guidelines from this stock exchange or that stock exchange". They cannot relate it to day to day business in the way they are actually creating and selling products.

So, just to summarise because I know I've got to stop shortly, we think that the SRI regulations that are coming into play in July are going to have a bigger impact in shareholder relations than has previously been seen. If we look at, say, the Local Authority market which now owns about 16% of the assets that are floated in the UK, these are much more progressive in their thinking. They for a long time have had corporate governance policies and voting policies, but they want to take them further. And when you are looking at nearly 20% of the market having such a strong influence - and it has to be agreed they are also politically motivated - this will have a much greater impact on the way that fund managers address SRI and corporate governance than they have in the past. Everybody wants to run Local Authority pension funds; they are very lucrative parts of the market to have business in, and they are the sorts of pension funds that stay with fund management companies for a very long time.

We therefore are seeing fund managers gearing up to address this particular segment of the market in a way that they never did when it came to the straight-forward Cadbury/Greenbury aspects of corporate governance. We therefore see that the environment has much wider implications, and the SRI regulations have much wider implications, than the press is currently giving it credit for. In fact, we see very little mentioned in the mainstream press at the moment, but over the next two to three years there will be much more pressure coming out on these issues than people are aware of. Going back to companies and why they should embrace these new regulations, why they should embrace the shareholder requests for improved performance is that they are achievable - but they are also profitable for companies as well. It is not expensive to set up good environmental programmes within companies. It can be achieved very quickly, and it can also be achieved very economically.

This is why at Manifest we are now reviewing the environmental profile of all the companies in our universe. I think that, as at last week, we got to about 200 companies in our universe that we have now analysed for their corporate governance structures and environmental structures combined. We are tending to see that the progressive companies from a corporate governance perspective are also embracing the change of environmental and socially responsible investment as well. So, hopefully, we'll start to see some performance indicators coming out of this in the not too distant future. But we think it is something that is going to have a profound impact on shareholder dialogue. It is not going to force everybody to vote at their AGMs and EGMs, but the shareholders that care know that in order to get their view across they are going to have to have dialogue with companies if they want them to change. They know that voting as well as informing companies about their policies is a very important way of getting their point across. *[Applause]*

Afternoon Questions and Discussion

Elizabeth Forbes, Business in the Environment: My name is Elizabeth Forbes and I am saying something not necessarily because I want to but because I feel I have to, because of the different directions from which I am coming and the different points

that have been made today with which I feel strong links. I am a professional corporate communications consultant, I'm also a member of the Institute of Directors, and I hold the Diploma in Company Direction, although I'm not a chartered director, nor moving in that direction. Perhaps more importantly, at one stage I also owned and ran my own company, so I am very sensitive to the question of burdens on directors and the need to be looking in all directions at the same time - usually omitting the question of actually running your own company and satisfying your customers! I also happen at the moment to be the communications manager for Business in the Environment (BIE), so I link in quite strongly to the environmental messages.

But through all that, I am very much coming from the point of view of corporate social responsibility, not at all as an end in itself because I do not personally think that that is company's business. I think, from my experience, they have other things to focus on which are about running a profitable company. So the question really comes down to this. There are some companies which subscribe very strongly to socially responsible investment, and the latest index of corporate environmental engagement which BIE published showed that 19 out of the FTSE-100 Top 20 companies took part in the index - but the overall figure for the FTSE-350 as a whole was only 100. Now, whether it is the largest companies that are doing it, for whatever reason they are doing it, or whether it is the small companies which don't have the time or don't perceive the benefit of doing so, this is something which has to be looked at. But the main question really, is how you get the message across to the smaller companies, the ones who are not doing it. It is actually for their corporate benefit to adopt these approaches in terms of increasing profits.

It does seem to me that the key way in is through investors. The important thing for the investors is the point that came out of the company law review proposal, which is that they actually have to demonstrate to the companies why they have a legitimate interest in that company behaving in the way they want it to, i.e. that it directly relates to that company's activities, not simply to such activity being generally socially desirable. I would be interested in hearing peoples' comments on how we get the message across legitimately to companies who are not currently adopting that approach.

Tony Newton: This is to some extent one of those questions which any politician gets familiar with over the years, which are observations which you feel you've got to end with a question. I understand that. And, indeed, I hope that people who simply want to make observations without feeling that they have somehow got to turn it into a question will, at least as far as I'm concerned, feel free to do so. Now, resting principally on your observations, I found, I think, really nothing at all in what you said that I disagreed with. I think I said implicitly that I thought that getting the message across or putting the message in terms which will make it receivable by small and medium enterprise is quite an urgent challenge which we all face.

I probably did not say it so clearly, but personally, and I don't know whether Sarah (Wilson) would agree with this or not, I entirely agree social responsibility is not what companies are set up to do as their primary objective. On the other hand I think, and this is where Sarah and I would certainly agree, that nothing is more certain than that

you won't be successful as a company if you are labelled a 'socially irresponsible company'.

Perhaps the clearest way of getting the message across is to take I suppose the ultimate example, whether it is fair or not, of a sufferer from having had the image go wrong in related fields, which is probably Monsanto at the present time. On an earlier occasion I suppose it was BP, wasn't it, that had the Brent Spar business. Subsequently there was a lot of argument about who'd been right and who'd been wrong, but there was no doubt that the perception of social or environmental irresponsibility did the company a lot of damage. So I think it may be easier to get the message across by pointing to the risks of ignoring this and saying "its nothing to do with me", as a means of getting people to focus on the fact that at least they need to to give it a bit of consideration. It is not their primary business to do good work in the locality; they need to think about the relationship between how they are perceived in the locality, whether it is the national locality or a local community. Their aim is to maximise the profits of the business for their shareholders - the long-term interests of the company and all that. *(To Sarah Wilson)* Are you broadly in line with that?

Sarah Wilson: I would absolutely agree with what you said there, Tony. No, it is not company's role to be creating social policies. But what they can't get away from is the fact that, directly or indirectly, they will have a consequence on social policies wherever they operate. If you are, say, in the DIY business and you are buying in brass from India and people find out that the way that this is made is socially irresponsible, because they've got young children being seriously harmed in the process, then there will be consumer boycotts of those goods and services.

We talked to a lot of companies outside the FTSE-350 as part of our environmental analysis, and there is a surprising number who have taken part in our questionnaire; in fact, we were very pleased at the level of take-up. They do go about adopting environmental policies, but not necessarily in the way that BIE might hope in that they don't feel the need to join an organisation like BIE to have an environmental policy. But they do set up their own environmental management systems. What is more surprising is the number of companies who say: "but we don't have any environmental impact in what we do". Local Authorities are very tuned in to something called "Local Agenda 21", which harks back to the Rio Earth Summit where everybody committed to trying to reduce energy consumption, for example. But we hear from software companies who say: "we don't have any environmental impact". So we say to them: "well, do you print manuals? You use paper, you use ink - what sort of inks are you using? You consume electricity; do you turn your lights off at night, for example?". All of those things can add up to an environmental policy which can have a positive impact. But any small or medium sized company who wants to have a good relationship in the market these days has got to have an investor/relations policy which is clued up enough to realise that there is a very large segment of the market that wants to know virtually the inside leg measurement of all of the senior officers and managers in that company. What they are doing about their environmental impact is going to be a factor on the investment agenda going forwards - they just cannot get away from it.

Perhaps the IOD do have something in their newsletter about it. That would be one way of communicating to the smaller companies. But over the next year as the statements of investment principles are published, and more fund managers then project them onto the companies themselves, the companies will realise it is an issue that they will have to address. It will seep down.

Sarah Murphy, Forum for the Future: I just want to make an observation, really. I think perhaps some of the things that you have said have been a little bit optimistic about the interest that consumers, particularly, take in this particular issue, and the link between social performance and financial performance. There was a conference board report in the US that was written a couple of years ago which basically came to the conclusion that there was no positive link between social performance and financial performance - although we would all very much like there to be one, and it may be that, with further research, we will find it. I think that this means that the pensions legislation, particularly, is one of the most important things that we can work on, because it means that there is something that has to be out there and be published, and it has to be taken account of by investors rather than consumers. I do think that that is the way in, because unfortunately that positive link has not been proved sufficiently to enable companies to have to take these issues on board.

Sarah Wilson: Well, I think the proofs are there but they are not very well known. I spent about four days surfing the web about a month or so ago, trying to pull together as many academic papers as I could on this issue. It took me a long time to find them, but find them I did. When we gave a presentation on Friday to some local authorities, a colleague who was with me from a management firm produced about ten share price graphs just to highlight some of the issues where social performance had had a major negative impact on companies. I've got your card now, so I'll send you the links to the various sites that I found, which actually do demonstrate a positive financial correlation between a company's social performance and financial performance.

But to see this you only have to look at, say, a company like Coca Cola, who had problems in Belgium with their bottling plants. That was an issue not only of consumer boycotts but also of management incompetence in not actually managing local market expectations, and having too cavalier an approach to the various local management structures that it has. Now, Coca Cola is a company which has changed its national management structures to take account of local requirements, but I think Coca Cola lost something about 20% of its share price performance over a very short period of time.

You might also take a look at de Beers as well, where there are issues about de Beers and the cartel in diamonds - they control it. There are issues about Sierra Leone diamonds, for example, where they are buying in diamonds from the rebels, so possibly now those diamonds are actually tainted diamonds. There are also other issues, for example, in how de Beers manages its mines, and how its management practices are affecting the health of its employees. The great communications explosion that we are having I think will aid your particular objective, which is for consumers to be aware of what company management practices are or are not. But there must be lots of private clients out there who probably don't read the annual reports, or possibly the annual reports don't contain enough information. I know that

is a subject very close to the heart of the ACCA, who is encouraging better disclosure of environmental impacts on companies because they are long term liabilities for companies. It is something that does need to be factored into the figures.

Tony Newton: I don't think there is very much I can usefully add to that, except say that I share your scepticism, or reported scepticism, about the extent to which you can certainly at the moment demonstrate a positive link between being "socially responsible" - whether its helping charities in the locality or any other possible manifestation of that - and doing well. I mean, I may suspect it and hope it, not least because I chair a couple of charities, and we rather rely on companies thinking that it is a good thing to support us. But, in answer to the earlier question, I deliberately put my point the other way round. I mean, it may be at the moment difficult to prove the positives, but it is not at all difficult to prove the negatives when you are perceived to be socially irresponsible. So, at the very least, it is something that everybody needs to think about. I return to the formulation I adopted before.

[TEA BREAK]

Steven Young: It is my pleasure to introduce Professor John Parkinson from the University of Bristol. He is a lawyer, and, perhaps even more relevant today, he is a member of the UK Company Law Review Steering Group. He is going to talk on the subject of corporate governance and reforming company law.

Corporate Governance and Reforming Company Law

Professor John Parkinson, University of Bristol & Member of the UK Company Law Review Steering Group

John Parkinson: Thank you very much. I want to begin with a few brief remarks about the company law review process, and then I'll move on to tell you something of what the review has so far said about corporate governance. As to the review itself, I should just say that I am speaking here in my individual capacity. I am required to issue a disclaimer whenever making public pronouncements, so nothing that I say necessarily reflects the views of the Steering Group as a whole.

The review was started in March 1998 by the then Secretary of State for Trade & Industry, Margaret Beckett. Shortly after announcing the review, the Steering Group was formed to oversee the review process. The Steering Group itself is independent, which is to say that it isn't the DTI that is conducting the review but the Steering Group. The Steering Group will report to the DTI finally next spring, and at that point the government will decide what to do, and whether to implement all or any of our recommendations. But until then it is our review and not the government's.

It is a broadly based review. There is a long history of company law reviews in this country; they used to happen about every 20 years. The traditional pattern is that they are chaired by a senior judge, so they are called things like the "Cohen Committee" and the "Jenkins Committee" and so on. Our review has broken with that tradition in that it is not chaired by a judge; it does not in fact have a majority of lawyers on it. It is a broadly based group of some lawyers certainly, business people, accountants,

economists, and members of various other professional groups. The thinking behind this is that company law is more important than just sorting out technical, legal rules. Once you put lawyers in charge of this kind of process, they tend to get into nit-picking, and concentrate on the technical problems that have caused difficulty in practice. The review is meant to reflect the fact that companies are absolutely fundamental to the operation of the economy and of course they have an extremely important place in society. So this is more than just a law reform exercise as such.

The other thing to say about the review process is that it is a consensus building operation. The idea is that our report should command the maximum possible support. Of course, not everyone is going to agree with everything. There is a risk of “lowest common denominatorism” if everyone is supposed to agree with most of the proposals; hopefully, so far we have avoided that risk. The advantage of consensus is that hopefully we will get it more or less right, and if there is broad agreement to our proposals then they stand a much better chance of being implemented. The consensus model is reflected in just how many people and how many different types of people are actually involved in the process. There is the Steering Group itself, which I’ve said is broadly based in terms of the professional background of its members. Also I think some of the views of its members vary; they certainly don’t all come from the same direction.

The detailed work is done by a series of working groups. There have now been, I think, over 200 people involved in these working groups, with membership ranging from the TUC and various NGOs to executive directors of leading companies, institutional investors, fund managers, and so on - a very broad range of people. There is also the consultative committee that Lord Newton mentioned earlier on, of which he is a member, which represents most of the large organisations with an interest in this field. So we are trying to bring most parties on board, or at least they are some way involved in the exercise.

Our output so far is two main documents; there have been some subsidiary documents, but I won’t mention those specifically. The first document, the Strategic Framework, was published in February 1999. And then in March of this year we produced this huge telephone-directory-like object, called ‘Developing the Framework’. Now, I am not going to discuss in any detail most of what is in these documents, since there is a huge amount - particularly in the second one. What I want to focus on is just the following things. First of all, the first document raises the question: “whose interest is it that company law is supposed to be protecting?”. That is what we call the “scope question”. This relates to governance in the sense that one can define governance as being the mechanisms that cause the company’s management to act in accordance with the proper objectives of the company. Now that of course raises the question of what are the proper objectives of a company. This is the scope question, which is obviously logically prior to issues about mechanisms of governance, and so we address it first.

It is then answered in the second document, in the sense that we give provisional conclusions on that question and then we discuss methods of implementing those conclusions, in terms of director’s duties and broader reporting. I will come to those things later on. The other thing I want to talk about is governance as a disciplinary

mechanism and the various mechanisms that are used in order to control management and the objects that management pursue. I will come to that towards the end.

I can begin then with the scope question, that is: “whose interests is company law meant to be serving?”. Apart from the fact that this is a logically prior question in a fundamental review, we were specifically asked to consider this question by the government when it set up the review. Presumably, one of their reasons for doing so is connected with the stakeholder debate. This was current around the time of the last General Election. But the issue goes back really right to the beginning of company law: it certainly predates stakeholder language. The way in which we tackled it was to focus on two areas. The first was to ask whether company law is sufficiently supportive of productive relationships between a company and its employees, its customers and its suppliers. So this essentially is an economic argument: can company law do any more to help build those economically important relationships? The second way into the issue was about corporate social responsibility. So here we asked if shareholder interests are over-riding, whether that is compatible with a company acting in accordance with such ethical or social responsibilities that companies might be thought to have. So those are the two ways into the issue.

I begin first with the economic relationships. Legal accounting and economic models of companies see companies as financing mechanisms, and the concern of governance within these models is to reduce the agency costs - the costs to shareholders of having directors who may act in their own interests rather than in the interests of the shareholders. But of course it is a truism that companies depend for their success not simply on the providers of finance but also on their employees, and their suppliers, and their customers. So the question is whether there is anything that company law should be doing about these relationships as well. Of course, many relationships that a company has will be short-term and they will be at arm’s length. A company does not need to have a very profound relationship with its supplier of stationery, so there is no problem with many relationships. What we are concerned about is long-term relationships in which one might expect some commitment from both parties. A company needs to have stable relationships with many of its employees so that those employees will become properly trained, will acquire firm-specific knowledge and skills, will be loyal to the enterprise, and will use their creative abilities for its benefit. Those kinds of relationships require some reciprocity between the company and the employee, and for this they will need to be fairly long-term.

There may often also be a need for long-term relationships of a co-operative nature between a company and its suppliers and its customers. Within these relationships, suppliers may make, again, firm-specific investments in terms of physical capital and also in organisational set-ups and so on. Co-operative relationships with employees, customers and suppliers are thought to be problematical. The reports of the “Tomorrow’s Company” project and the Commission on Public Policy and British Business both came to the conclusion that many British companies had problems with long-term relationships and that these problems were adversely affecting the international competitiveness of many British businesses. That is the sort of issue that we were trying to address.

We suggested - without necessarily supporting either model - two different approaches. The first we rather clumsily called 'Enlightened Shareholder Value'; it went through a number of name changes in the process, but that was the best we could come up with. This suggests that there is nothing radically wrong with the current system, at least as far as company law is concerned or about which company law could be expected to do a great deal. This model suggests that, because these relationships are supposed to be for the company's economic benefit, they will necessarily be for the benefit of the shareholders. So there is no need to get rid of the principle that shareholder interests are over-riding. The problem is just that companies might be too short-termist, so they might not realise that their shareholders' long-term interests benefit if they can construct appropriate long-term relationships. Creating these relationships may involve some give and take; it may be that the company will have to sacrifice immediate gratification, if you like, in order to develop a relationship of trust with the other participants. So there are short-term costs arising from relationships, but also long-term benefits; the benefits are there - the whole idea is premised on the fact that these relationships will benefit the company and its shareholders, and so there is no fundamental problem with the law as it stands - it is merely a matter of time scale.

The advantage of sticking with the traditional position is that it supports a single objective, ultimately of shareholder wealth maximisation, and a single objective is easier to understand and to implement, the argument goes, than a multiple objective. If we are trying to serve the interests of a range of different groups who may have conflicting interests, that is a more difficult proposition than ultimately just serving one interest. And, secondly, for rather similar reasons, accountability is a more straight-forward concept if there is just one group whose interests are being served. If there is a multiplicity of groups then lines of accountability become much more complicated. So those, if you like, are incidental advantages of retaining the current position, suitably spruced up in ways I will discuss in a moment.

The rival view we call 'pluralism', and again this is an economic view; this is not to do with social responsibility as such at the moment. This view says that actually the problems are greater than I've just mentioned; there needs to be a balancing of interests: it is not the case that shareholder interests should always over-ride. The reason for this is that within stakeholder relationships, the stakeholders all make investments in the company. So if an employee acquires firm-specific skills, those give that employee a stake in the company. Likewise, investments made by suppliers and customers give them stakes. They have got an investment in the company. The problem with these investments is that they cannot be completely protected by contract. The reason they can't is precisely because they are long-term. So, at the beginning of one of these relationships it is not possible to anticipate all the problems that might arise in the course of it. Because they cannot be anticipated, the parties can't agree about what should happen in the event of various contingencies coming about. So there cannot be complete contractual protection. Therefore these interests are vulnerable. They will be protected as long as the company thinks that it is in the company's interest to maintain the relationship. Now that is the way the enlightened shareholder value model works. It recognises that there is a commonality of interests, and for as long as the shareholder interests are served by the maintenance of the relationship, then the relationship will survive.

It follows from that, according to the pluralists' analysis, that sometimes management acting on the shareholders' behalf will have incentives opportunistically to breach implicit undertakings - understandings made with the stakeholder groups. That being the case, the analysis goes, the incentives of stakeholders to make wealth enhancing investments are undermined, or certainly diminished. Their interests are not fully protected; they are liable to be sacrificed in appropriate circumstances, they are therefore prone to make fewer of these investments than would be economically desirable. That being the case, it should be the objective of management not simply to act in the shareholders' interests but they should balance the interests of various groups. Therefore the objective of the company is no longer to maximise shareholder wealth – it is to maximise the aggregate wealth of the various constituent stakeholders.

Our provisional conclusion in the big green document (*Developing the Framework*) favoured retention of the first model, in essence. Now this was not because we necessarily rejected the pluralists' analysis. I think we were sympathetic to the idea that stakeholders do make investments that are vulnerable. Our main concern was with whether it was feasible for company law, as a mechanism, to address the problems that stakeholders face, and, relatedly, whether if company law attempted to do so there might not be countervailing costs that could outweigh the benefits of trying to protect stakeholders through company law.

What would really be, if you like, the “headline way” of protecting stakeholders would be through directors' duties. So pluralism would suggest that you should have pluralist directors' duties. That would mean that the directors should not simply have a duty to the shareholders - they should have a duty to all the relevant groups, and they should resolve conflicts between these groups by balancing the interests. Now if that is a duty, a duty implies some kind of enforcement mechanism, so that would mean that if one of the parties was unhappy with the way in which the directors had balanced interests, they might be able to go to court and say: “we think that the directors are in breach of their duties because they failed adequately to take account of our interests”.

The problem with this is that there are no objective standards that the court could apply to decide whether the directors had acted properly or not. The courts are not in the business of second guessing business judgements. Courts apply fairly rigid rules and standards to identifiable fact situations. This isn't really the kind of thing that they are capable of doing. It would follow from that that it would not be sensible to impose stakeholder pluralist duties; all you could do realistically would be to have a stakeholder discretion, so that directors would have the discretion not to make shareholder interests over-riding. Now, the problem with that from a pluralist point of view is that it does not really create the safeguards that the pluralist theory says that stakeholders need. If directors just have a discretion, they may not actually change their behaviour at all. Why, simply because the law has announced that from now on they have discretion, should they behave significantly differently from the way that they do now? One might just note in passing that stakeholder systems - I am thinking particularly of the German and the Japanese – do not rely on directors' duties to make them function as stakeholder systems. They rely on much more embedded institutional

mechanisms, very different shareholding patterns, and of course co-determination in Germany as regards employee interests.

So our conclusion was that it was not at all clear that there is very much that company law could sensibly do to give effect to a pluralist model, and there were dangers, if it tried to do anything, that there might be a weakening of accountability. Those dangers, given the very limited benefits, were not really worth running. So our conclusion was to support an inclusive version of directors' duties. I'll say what that means in a moment.

Before that, I would like to deal with social responsibility; this is the other way in to this question of whose interests should be protected. A standard response here is that this is nothing to do with company law, but to say this is entirely circular: the point is simply that company law is about "companies", it is not about wider issues. This is not much of an argument. More substantively, the argument is that problems about how companies treat other groups - and society, the environment and so on - can actually be controlled by other bits of law. These other types of law - external regulation, as you might call it - are actually better ways of dealing with these problems. Now that is not entirely true, because there are limits to what can be achieved by external regulation. I will not go into this at any length. But it is fairly obvious, for instance, that external regulations, environmental standards and so on tend to deal in minimum standards. They don't say what the best possible outcome would be: they set standards that most companies are reasonably capable of complying with. So it may be that many companies could actually perform a lot better than the law requires of them. And the law is inevitably reactive - it waits for sources of damage to arise and then legislates against them, and that can take a very long time. So to say that companies should just maximise profits within the law is not a wholly satisfactory response, because the law is slow and it has all sorts of problems in trying to make company behaviour consistent with some conception of societal interests.

The other response is to say that we needn't worry about this any more because there is no longer a conflict between long-term shareholder interests and the interests of society, because of the reputational considerations that have been discussed several times already. Now, of course, reputation is extremely important, and the Company Law Review intends to build on that mechanism. It cannot be true, however, that there is no ultimate conflict between company interests and shareholder interests. For that to be true, the reputational mechanism would have to work perfectly. So, in other words, any kind of infraction of what was thought to be desirable behaviour would have to produce a reputational cost at least equivalent to the benefit that the company gets from behaving irresponsibly. Now that pre-supposes that the relevant markets in which companies operate are full of people who actually care about all of these issues. People care about what happens to them directly; there is a range of things they care about happening to other people and there is a range of things they don't care about very much at all, quite frankly. Also, of course, for this mechanism to work perfectly it would have to have perfect information. Consumers, the capital market and so on, would have to know everything about what the company were doing and be able to compare how each company was doing - whether one company was doing better or worse than another and so on. That involves a vast amount of information that simply does not exist. People know the headline issues; they know about the dumping of the

Brent Spar, but they do not have enough information to compare day-to-day performance. So this mechanism doesn't work perfectly; it is extremely important, but it doesn't quite live up to the billing that it often gets.

So what should company law do about this? Well there is, of course, a pluralist response here, which is to say that companies should be obliged, as a matter of directors' duties, to take account of all these various interests. Now, for the reasons I said before, this could only be a discretion. A duty simply could not function; mechanics do not exist that would make it function. Now I myself have some sympathy with the idea that such a discretion wouldn't be a bad idea here - you might call it an "ethical over-ride", if you like. You might say that the primary duty is to act in the interests of the shareholders, but that, if directors considered it unethical or whatever, they would not in particular circumstances have to act in the shareholders' interests. I imagine that is not an unfair characterisation of how quite a lot of companies behave. I don't think many directors would say: "oh well, even if we thought something was unethical, we'd still do it if we thought it was in the shareholders' interests". However, that was not the ultimate conclusion that we reached. It was thought that doing this would really be a bit of a gesture; a discretion of this kind that could not be enforced looked a bit like gesture politics, if you like, and again it may have adverse accountability issues. So the line we came down on, in the end, was the idea of inclusiveness which takes the form of emphasising the link between being responsible and profitability. There is clearly a large common interest between society as a whole in its various aspects and shareholder interests. We want to emphasise that link. We also want to strengthen the market control mechanisms; we want to make the reputation effect work more effectively.

So that brings me to our proposals. The first proposals concern directors' duties and the second concern reporting and disclosure. These two things should be seen very much as complementary. The directors' duties are backed up by the disclosure mechanism: the two go together. You can see that issues that are mentioned in the duty are also mentioned in the profile of items to be reported on, so the two things are integral. The statutory statement of duties says that the core duty is to promote the success of the company for the benefit of the company's shareholders. In pursuing that objective, the directors should take account of the long term as well as the short-term consequences of their acts; they should take account of the need to foster appropriate productive relationships; they should take account of the impact of their decisions and policies on local communities more broadly, and on the environment; and they should also have regard to the need to maintain the company's reputation for high standards of business conduct.

Now, our view is that this does not actually change the law. That is the law already. So, for example, this formulation does not give standing to stakeholder groups to sue under company law. The only people who can sue are the people who can sue now - essentially, the company itself, actually, but I won't go into that. So there is no right for these individual stakeholders to bring actions. The duty is only breached when there is actually a loss to the company - we are not talking here directly about losses to the stakeholder groups, we are talking about losses to the company itself. So, if I can just give an example of what this means, let us say that the directors are making a major decision that potentially has a serious environmental impact. In making this

decision, they just don't consider the environmental effects. The result, as it turns out, is that there is huge environmental damage. That means there are vast clean-up costs to the company, there may be legal liability on the company, and there will be perhaps significant representational damage. Now, if there are all those losses, and those losses have been suffered by the company and can be attributed to the negligence of the directors - in other words, the failure to consider the environmental impact was negligent - the directors will be liable to the company, and they will have to compensate the company for the losses that it suffered. But that is the case now. What I have just said is already the position. You might say: "well, so what is the point of this?". The answer to that is that, first of all, the objective is to make the law accessible. As Lord Newton said earlier on, directors' duties are not accessible: they are contained in a series of 19th century and later cases. These cases are obscure, and they conflict a bit, and lawyers disagree about what they mean. If you think that you are trying to design modern company law, you would not think that the absolute centre point of company law should be contained in a series of Victorian cases in old leather-bound books.

So we are trying to make the law accessible. The point of accessibility is that it will remove misconceptions; this is really the point that Lord Newton made - that many directors (and I think the Institute of Directors' own survey) reveal that directors actually have a very hazy understanding of what their duties are. They seem to believe, for instance, that they cannot sacrifice profits for shareholders, even in the short-term, if the benefits are rather speculative. Well, that is just not the case. The whole point is that you must exercise your judgement to produce the best long-term benefit to the shareholders. So the point partly is to correct misconceptions. And the other point is really just to emphasise the importance of these relationships and effects and so on. By actually building them into this clear statement of what directors' duties are, we hope to raise the profile of these issues; but you must see that in combination with the disclosure requirements. These things become, if you like, much more visible because the law tells directors they have to think about these things if they are relevant. It also then is going to say: "you also have to report about what you are doing with them". The two things go together.

So I now quickly turn to the wider reporting proposals. I slightly hesitate about this, knowing that there are a lot of accountants present (of whom I am certainly not one). Our proposals, in essence, are to have a statutory "operating and financial review". This will be mandatory. The review itself will be mandatory; particular parts of it will be mandatory, while other parts will be mandatory if they are material. So, for instance, they will review the development of the business, the sources of wealth generation in the company and its competitive position - these are all things that companies will be required to report on as a matter of compulsion. Other things, such as the company's key business relationships, environmental policies and impacts, ethical and community issues and so on, will have to be reported on if they are material. Materiality is judged from the point of view of the company. That means to say that these things have to have some significant economic impact on the company itself, and that is a decision for the directors to make. If, however, they think it is material, they have to report on it and there will in future be reporting standards in relation to these particular matters.

So, once they are reporting on, say, the environment, it would not be open to the directors to be rather selective, as sometimes is the case today - just to point out the bits of good news. Having made the decision about materiality, there will be reporting standards that require a proper account to be given of the relevant issues. Disclosures would be subject to audit, but of a rather limited kind in that it would not be the function of the auditor to second-guess the materiality question. Rather, the auditor would have to judge compliance with the reporting standards, internal consistency within the accounts as a whole, and matters of factual accuracy that are reported on.

So all of this is in part a response to what has already been mentioned - the current bias of financial reporting against intangible assets. The whole idea is that companies are worth far more than just their intangible assets; these other things are not currently adequately reported on, and we are trying to address that. So companies have to report such things as their key relationships. The market will be able to value those relationships more effectively, and that in turn will emphasise the importance to managements of developing these relationships. And finally, on this point, I should just say that, whilst materiality is seen from the point of view of the company, of course once you are requiring companies to disclose large amounts of environmental information in accordance with prescribed standards then you are providing information to other stakeholder groups, and the interests of these stakeholder groups are very much in mind in the review process.

So what is hopefully going to happen is to make more rational the reputational mechanism - the market pressure mechanism for improving social and environmental performance. By having more information - more accurate, reliable, unbiased information - these kinds of market pressures to improve corporate performance should increase and become more effective.

I am conscious of having about exhausted my time. But I am also conscious of having a rather long time in which to answer questions. So if I can just talk about the final thing that I have not yet addressed - which I was going to address anyway and which has been fairly extensively touched on - this is essentially the Combined Code. What we do in the very large green document (and this is really just the tip of the iceberg of the work that we did) is to review governance as a disciplinary mechanism. In other words, how effective is governance, putting it rather bluntly, for removing under-performing managements or (more positively) in getting good, well-performing managers into position? There are, of course, several different mechanisms involved.

As has already been extensively discussed, these include the market for corporate control and also the board as a monitoring mechanism. There have been some suggestions that there is somehow a conflict between the role of the board as a monitor - or as a policeman or whatever you want to call it - and economic performance. This is not a view that we shared. What could be more important to economic performance than ensuring that the company has got a suitably qualified expert and energised management team? That is what monitoring is about. Of course, the history of the Cadbury Report is to do with "hygiene" issues. But monitoring is not just about keeping crooks under control - it is about making sure that companies are properly managed. So we don't really see this conflict between performance and monitoring. In fact, monitoring is essential to economic performance.

Our conclusion, having surveyed holistically how governance works, was that there certainly was room for improvement, and the bit that we could constructively operate on is the board and the monitoring role of the board. So we make a number of proposals, rather neutrally. Again, this is rather like “enlightened shareholder value” against “pluralism”; the way they are presented is that these are things that you might like to think about, and we don’t say that we necessarily think any of these things should be done. But the tenor of the suggestions is that the monitoring role could be improved, but at the same time we do not want to damage the other things that non-executive directors do. Non-executive directors, of course, also provide advice and contacts, and they are involved in strategy formation. Those things are very important and we do not want to undermine them. For that reason, we have not advocated a supervisory board because, whilst that does have some advantages in monitoring terms, it prevents non-executives from making a contribution to strategy.

One area in which there might be improvement is the nomination committee. The nomination committee, at the moment, is what it sounds like; it nominates to the board as a whole people who might be appointed. But the actual appointment and the decision to appoint is for the board itself. Executive management often dominate that process. Looking at things rather cynically, you might wonder whether people really choose rigorous monitors to monitor themselves. So one possibility, and it is only one possibility, would be to transfer the appointment role to the nomination committee. Of course, ultimately directors are elected by shareholders, but that is usually little more than a formality. Another possible improvement would be to have a majority of non-executives on the board. That would address the fact that non-executives do not have any powers different from other directors. If non-executive directors are in the minority, if it comes to a fight the non-executives would lose if the executives act together. A final possibility would be to have some monitoring obligation actually put into the Companies Act making it explicit that it is the role of the board to monitor the performance of the management. So that would be something that would actually go into the Act and not merely be a matter for a Code.

Finally, I should say that the ultimate future of the Code, in terms of who has got control of it, is not at the moment clear. As you know, the Stock Exchange is demutualising. The effect of this is that the Code is now residing with the Financial Services Authority and not the Stock Exchange. Where it will end up is not yet clear. That is one of the things that we are considering. I have run out of time, so I won’t attempt to pull all this together. I’ll just stop. [*Applause*]

Final Discussion

Steven Young: We will depart from the programme of events slightly, and pick up on the finer points you were talking about there about the board of directors. I would just like to introduce you to Ralph Ward, who has been able to join us at the last minute. Ralph is a widely respected commentator and publisher on corporate board matters in the USA. He might like to reflect on what he has heard in relation to the UK and maybe make any observations about the US.

Ralph Ward: My name is Ralph Ward, and I am speaking at another conference in town, but I saw your topic list and the guest list. This looks like a very exciting programme, so I decided to be a gate-crasher for the afternoon and barge in, and I have found very enlightening the topics I have heard, particularly Lord Newton's comments on some of the issues involved in dealing with bringing governance issues home for boards; actually saying: "how do we take these themes and these concepts and these concerns, and make a dozen people sitting round a table put them to work in the real world?". I edit an on-line magazine called 'Boardroom Insider', and I just have a book that came out on the topic; it is a collection of items that deal more with the realities of boardmanship, maybe, than with the major issues of governance.

I would have to agree that how you make governance work as a real work-a-day topic might be one of the most important boardroom aspects throughout all of the western world. It is probably one of the least studied and least worried about, but it is the one that the directors who serve on the boards probably have the greatest problem with. It starts out from a sort of bulls-eye circle with the major issues of the board; issues of how we put an effective director evaluation programme into effect; how we effectively evaluate management; management succession programmes; major themes of running a board effectively. Then it narrows in a bit to some of the dull realities that directors nevertheless never seem to get good advice on but need help on. Minutes; meetings; having to do twice or three times as much as they did ten years ago when their "paid" jobs are actually taking up even more of their time also. Structuring information flow: trying to find out more about companies with less time when they have the internet out there that can swamp them with information.

Dozens and dozens of items like this, I found from directors, are important; then it (*the Boardroom Insider*) narrows even further to the more personal aspects of the board that people don't talk about outside of the boardroom but can be some of the trickiest problems. "I am a non-executive director serving on this board; management has a new proposal which it is very highly in support of. The other members of the board are going to wave it through, but I personally believe that there is a disaster in the works, and no-one will listen to my voice on this. Do I quit? How do I change minds on this?" "We have a member of the board who has been here for ever, and is not pulling his/her weight any more; how do we discreetly edge this person off?" "We just had two directors engaged in a screaming fight at our last board meeting; how do we discreetly move on from that and try to heal from that experience?" I guess that would be my contribution.

The comment I'd like to make on this is to welcome anything that can be done to compile this material - this sort of folk wisdom in the boardroom, because the people who are actually in the board and who are asking these questions often find that there is someone else in another boardroom who has had exactly that same problem arise

and has found a way around it or a way of dealing with it. Anything we can do to compile, tabulate, co-ordinate and bring this information together on a professional basis to help the people who serve on the board to be more effective, I think, would be of great benefit.

Steven Young: Does anybody have a question at all?

Sarah Murphy, Forum for the Future: Thank you. It is a question and a comment. The first one was going back to the issue of directors' duties. I was wondering why it was necessary to make the reporting of environmental and social information dependent on materiality, and whether there is any way in the Company Law Review to make mandatory reporting on those issues, de-linked from directors' duties, so that we do not have to rely on defining or not the directors' duties towards stakeholders to enable this kind of information to be presented necessarily by all companies.

The second thing was the issue that you raised, Ralph, which I think is becoming more and more important over here in the UK, which is the practicalities of being on a board. I think you are absolutely right when you say these are the sorts of issues that tend not to be dealt with in the public domain, which is how people sitting around the board room table actually relate to each other and the kinds of issues that make it through. I thought it was very interesting at a conference I was at a couple of weeks ago, where Yves Newbold, who now runs the Ethical Training Initiative, said that in 15 years of sitting on boards she had never heard anything discussed from the environmental or social perspective on a board. And I found that extremely depressing. Now, it is hard to say whether it is true; I don't sit on any boards myself - but it was a very depressing comment on boards today.

John Parkinson: Yes, thank you. On the de-linking point, there is no logical necessity to make environmental and social reporting connect with the directors' duty to that effect. I'm not quite sure why you ask that question; do you think that stipulating the directors' duties part might not happen, and that therefore we would sacrifice the reporting? Is that it?

Sarah Murphy: No. I guess I'm thinking that a lot of the concerns for stakeholder groups have been phrased in terms of directors' duties - that directors should have a duty of care to environmental and to wider social issues. But actually I think that what most groups want is mandatory social and environmental reporting on agreed indicators, so that there is then ammunition, if you like, for pressure groups to be able to go out and say: "well, this is important to society and you need to be doing something about it". I think that would then bring pressure to bear on the market mechanism around reputation which you are talking about. So I'm just wondering if there is a different way of doing this to get the market effect that you would like to have.

John Parkinson: Yes; as I said, there is no logical necessity. On the issue of mandatoriness, I think this is going to be one of the interesting outcomes of the consultation process. This large green document (*Modern Company Law: Developing the Framework*) is currently being consulted on, and people have until, I think, the end of July to reply. I can see an interesting debate developing about where the line stops

between mandatoriness and the materiality requirements. There will clearly be groups that will argue that the line should come very much further down than it does at the moment, and I would be very sympathetic to those kinds of arguments personally. The line provisionally in the document has been drawn where it has been drawn, but there will be pressures for it to be drawn lower down. The argument for having it as it is, of course, is the standard one concerning burdens on business - that all this information has got to be produced and reported on, and that it all costs money. Plus the fact that it is of varying degrees of pertinence as between different types of company, so to make it mandatory for everybody might look a bit odd. Those are the arguments for not saying that everybody has got to do all of these things.

Ken Peasnell: I wonder if I could make an observation, John, and then put a question to try and clarify the thinking of your group. I mean, one of the things that I've found difficult to understand in some of the stakeholder assertions about companies is that they seem to lose sight of what it is that we are talking about in corporate governance. I mean, the issue originally arose because we created a legal form (which Adam Smith intensively disliked, for example) which was all built around limited liability. Yet we have lost sight of that. In fact, what used to be a health warning, "ltd" after the name of the company, has now become a sort of badge of honour, and people do not feel they are real businessmen unless they have got that after their name - or "inc" in the US. The point that I am trying to make is that we set up a structure which started from partnerships as businesses. Then, once we had limited liability we had to sort of break with those things and gradually a creature emerged which is the modern corporation as we know it - and then people started talking about other stakeholders. You said that you basically come down really on the traditional view, but you are trying to take some of the obscurity out of it but also leave a clearer opening and take care of some of the stakeholder views.

How do you connect with that earlier thing? I mean the only thing, if I put it boldly, that is different about a giant partnership like the big five accounting firms used to be and a corporation is that one has limited liability and the other does not. In all the talk that I have ever heard about stakeholder views, nobody has ever said that they should be applied to anything other than limited liability corporations. On the other hand, it is the only obviously good distinction between the two; everything else seems to flow from it.

John Parkinson: Yes. It is, if you like, a contingent connection in that the effect of limited liability is to allow business organisations to grow very large, and the social responsibility stakeholder arguments are really a reflection of economic significance. And so, because it is limited companies that have got the power and the potential to create good and ill, the argument focuses on them. But certainly there are other kinds of business organisations that you mentioned that aren't companies which also are very powerful. But it is just that contingent connection. There is of course a whole historical and philosophical literature about what companies do when they take on limited liability. They are creations of the state, which puts specific liabilities on shareholders and says how they are entitled to behave.

Daniel Summerfield, Institute of Directors: The company law review process is clearly a matter of finding compromises. It is, of necessity, politically motivated to

seek out what is acceptable. But it seems to lack any statement of basic principles. You may produce twelve pages of explanation and comments on what you have decided are the key issues on a piece of a paper. I think this is, maybe, not actually doing the job it is supposed to do. It seems to me that finding the middle ground is not too easy if you trying to avoid infuriating business people at the same time as you are trying to placate some of the NGOs and pressure groups. Looking at the constituents and some of the working groups, it is probably understandable. So, as regards the statutory statement of directors' duties, for example, which perhaps is the crux of the matter, to what extent will that go towards clarifying directors' duties and so on? Or do you think it will require additional case law to do that?

John Parkinson: If I can just unwind part of that, you talk about the review being politically motivated. Of course the review is about much more than just the things I've talked about. It is a review of the whole of the company law, including the very detailed, extremely boring bits. And what motivated the review was the idea that the company law had got out of date and, rather than our traditional piecemeal tinkering with various bits that really just in the end makes the whole thing even more complicated, it was better to step back and look at the whole thing and produce (hopefully) a shorter, more integrated, more coherent set of rules. So the parts I've been talking about, whilst they are the politically more contentious and in my view more interesting bits, are actually in terms of the overall effort just a small part.

As to whether we are clarifying anything, of course, if you try to clarify something that is very complicated, it will take twelve pages or more. The fact that it takes twelve pages to explain it I don't think signifies that what we're doing is not clear; it simply reflects the fact that it is actually very complicated. And to try and convey the whole of the directors' duties in three simple short sentences would clarify nothing, because people will say: "what the hell does that mean?". So it is all obscure and lost within these rather vague words. It would be nice to have very short, crisp statements, but the world is not like that.

Steven Young: Maybe I can exercise my right as a chairman and ask a question myself to my two panel members (*John Parkinson and Ken Peasnell*). Much of the discussion that we have had today has been taking the position that we see governance as we have it now as maybe not being the first best solution. Maybe there is a better solution out there that we can move to; but we also know the fact that we cannot eradicate all types of corporate failures, and we cannot eradicate all types of managerial self-dealing or opportunism. There has to be some position where we have to have a trade-off before we have reached the optimal level of corporate governance. I just wondered when are we going to know when we have achieved that? When are we going to know that we cannot really do much better than this, and essentially we are tinkering at the margins so that it is not really going to have any first-order effect on how companies are run and how they perform?

John Parkinson: Well, I know of no mystical way of doing that. One can only look really at the empirical evidence. Colin Mayer mentioned this morning the work that he had done with Julian Franks that the review has found extremely useful - about what non-executive directors actually do in monitoring terms. He was talking about how it seems that poorly performing managers are only removed when the company is

actually performing extremely poorly, and not just poorly. Now, if one could improve that situation, one would have achieved something. I think the fact that there is empirical evidence of that kind suggests that there is a role for reform that would not be mere tinkering with marginal benefits, but it is very hard to know.

Ken Peasnell: I would take the approach of an economist here, I guess, and I would say that you should step back one stage and say: “are we talking about market failure, and is it more costly to correct that failure than it is to see it as a cost of doing business?”. I think I agree with John that we really want to see diversity around; bio-diversity in the economic sphere, if you like - I think the phrase was used earlier - because then we can learn from the experience of others. It would be difficult disentangling what causes what, as always in these things. But it is not clear to me that the evidence that is paraded suggests a fundamental market failure.

I mean, the reason I gave that example of a different kind of corporate form is that we are so used to companies that we get fixated on them. We forget, when we see the take-over battles in the press, that in fact the vast majority of take-overs are small and private, don't involved listed companies, and go through very smoothly. There are loads of transactions. There is a huge amount of competition in the product markets; as the markets globalise (especially when we go into the world of on-line shopping, and so on), the competition gets more and more intense. If you have intense competition in the product markets, you do not have to worry as much about a certain kind of corporate governance problem. New ones emerge, like the environmental one; you may find things are driven to the worst, but that raises much bigger issues that go well beyond simple, conventional corporate governance or company law reform.

So I suppose I would say, if there is market failure why aren't we seeing other organisational forms supplanting the company? If the corporate form is so bad, why has it in fact driven out most other forms? We have got mutuals; we have got partnerships; we have got limited partnerships – we are only limited by human ingenuity, really, and the costs and benefits of the different forms. So I think the burden of proof is really on those who say that we are not at an optimum. I am not claiming that we at an optimum, but it is by no means obvious to me. I mean, it is a simple fact of life which economics ignored for a long time that organising economic activity is extremely costly. Part of the cost of organising is tolerating failure. Failure may be a good thing.

Annita Florou, University of Warwick: You talked about the monitoring role of the non-executive directors, especially in removing inefficient managers; but it is very interesting to see, especially in the UK, that those poorly performing managers manage to get a prestigious job in a top firm, in less than one year actually. It is one issue to remove inefficient managers and another issue not to hire them in a very short period in another good company. It seems to me that probably an important reason for that is that non-executive directors hold so many directorships in so many companies; there are executives and non-executives - it seems to me like a family that exchanges roles and titles. So I don't know what can be done, or if anything can be done on that

maybe - in the States as well. I do not know if there is a difference and what is going on in both countries.

Ralph Ward: One thing that has made a difference in the States, and I think it is making a difference world-wide, is the time demand, especially on the matter you raised of the number of directorships a director can hold. That is an issue that has come up just within the last decade. It was hardly mentioned as a concern, I know, in the 1980s. Today, particularly in larger corporations, when searching for directors the boards will simply throw up their hands if they find out that someone is serving on two, three, four other boards, because they know that they are not going to have the time needed nowadays to dedicate to their company. So it is a case, I think, where you might say that the market itself is making a real difference for improvement.

John Parkinson: Yes, it is a real problem. One does get the impression that it tends to be the same old people who keep reappearing in different companies, and there is a case for broadening the range of people who become non-executive directors. The problem with that is expertise and familiarity with the way boards work and business issues. There is a trade-off, but it seems to me there is an argument for trying to explore the idea of wider range of people.

Steven Young: The larger UK companies, as far as I am aware, also actually limit the number of outside positions that their senior managers can actually hold.

John Parkinson: Yes, because it prejudices their ability to be managers.

Michael Mumford: Just a comment if I may jump in. It does worry me, when you are talking about company law reform, just what an enormous effort is involved in making reform. Ken alluded to this a little while ago. Such a lot of institutional arrangements are built in such an elaborate pattern that just a relatively minor shift in some variable can add all sorts of consequences, of which an awful lot are unforeseen. By "unforeseen", I have in mind the early American history in 1910 or thereabouts, when, in order to resist the build up of trust power, the banking laws were changed so as to insist that banks could only practise within the states in which they were incorporated. It had the most dramatic effect upon the patterns of funding throughout the whole of the American economy. You can think of similar consequences in Japan after 1945, too. So I can well understand why anybody on the steering group maybe feel a certain anxiety about the process.

John Parkinson: Yes indeed. Very chastening!

Steven Young: There seem to be no more questions. Let me thank the speakers this afternoon, and all of you for your attention.

Michael Mumford: Thank you again. Let me add my thanks to the other questioners, to the chair people, to all the speakers. Ralph - thank you for coming in. Thanks to all of you, for taking a day out to spend with us on corporate governance. I hope you found it an interesting and challenging day. Thank you very much for your attendance, and good night to you. *[Applause]*

END OF CONFERENCE