

OVERCOMING MOUNTING ANGLO-AMERICAN SHAREHOLDER CONCERNS

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A deteriorating picture

The late nineties share price boom from massive growth in reported profits raised few concerns of credibility, management remuneration or accountability. Massive falls in share prices in selected industries in 2000, and the emerging financial scandals, by last summer in Britain and the late autumn in America, however, have prompted widespread government, regulator and shareholder concerns in both countries. With over ten legislative enquiries, and further investigations by the Securities and Exchange Commission and accounting bodies, the effect of Enron and other failing mega companies will lead to major reforms in governance, accounting and auditing, and pension regulation in America. Equal concerns have been sparked in Britain by the earlier demise of Marconi, and other severe corporate setbacks compounded by Enron's demise in America and indeed in Britain. With huge losses by pensioners in both countries from companies like Marconi and Enron, including Enron's staff, the questions must be asked, Is this level of loss and volatility necessary, or tolerable? Does capitalism require ninety per cent losses of value in less than a year? Or is something generally wrong with the governance of companies?

Enron, Marconi, etc were shrouded in *tolerated* mystery as long as their share prices were rising. When it stopped, they virtually collapsed. What does this say about the competence, diligence and independence of their non-executive directors (and audit committees)? Or auditors? Investment analysts? Regulators? Etc. Markets cannot do their job without full transparency from all entities, and not least corporate managements. Unless resolved soon the dominant investment of retirement savings in equities could fall significantly in both countries (*pace* Boots) especially as investment risks increasingly fall on employees alone.

Hence the search for effective remedial action is urgent. Comprehensive effective remedies can be developed, however, only from a dispassionate analysis of the many interdependent causes of the crises.

The problem defined

The fundamental malaise underlying the major weaknesses and conflicts of interest now starkly emerging is the almost universal failure to discharge the ownership function in public companies. The desirable and government encouraged rise to dominance of institutionalised savings has meant the relinquishment to chairmen/CEOs and their executive colleagues of at least six major inappropriate powers. The resultant serious disabling conflicts of interest for non-executive directors, institutions and fund managers, auditors, etc has seen their independence compromised and their powers neutralised. All depend unduly on corporate management patronage. The corporate managements:-

- choose their 'independent' non-executive colleagues;
- choose the auditors on shareholders' behalf;
- choose the remuneration consultants for the non-executive "independent" remuneration committee;
- successfully influence their pension fund trustees and their fund managers to take a non-activist corporate governance stance on other companies implicitly in return for similar reciprocal passivity;
- have major powers of patronage also over most other fund managers seeking their pension fund business and frequently part of groups wanting investment banking or insurance business; and

- avoid separate advice to non-executive directors on the merits of takeovers and mergers despite the frequent clash with shareholder interests.

All of these compromised entities have prospered despite the increasingly apparent neglect of shareholder interests. Hence, despite a decade of reforms (stronger in Britain) all the intended defences have failed in an increasing number of major Anglo-American companies. Effective reforms must deal with all these inappropriate powers.

The cost of neglect

There are four strong forms of evidence that neglected reform comes at a high price.

- High corporate waste results from too many poor value takeovers and mergers (60% plus destroy shareholder value) and the failure to link management remuneration to sustained performance (little present link exists between high remuneration and corporate performance).
- Inability to control corporate managements causes investors to shelter in very wide spread portfolios, yet those who act as committed owners with concentrated portfolios (e.g. Berkshire Hathaway) significantly outperform them.
- There is the strong evidence of the last 18 months in selected industries and numerous mega companies that overpowered corporate managements can massively destroy shareholder value.
- A growing array of convincing studies (by McKinsey and many others) shows that well-governed companies (including truly independent non-executives) significantly increase both value and stability.

In sum, committed, knowledgeable, long-term ownership significantly raises long-term performance.

A damaging management restriction

Corporate managements also suffer an unjustified restriction. Fund managers being judged over only 2-3 years naturally support companies with expected short-term share price growth. With only four year (and falling) average CEO tenure in both countries, managements understandably focus on short-term performance to the detriment of most investors with far longer-term horizons. Hence both managements and fund managers are unable to play to their longer-term strengths and investors suffer.

The proposed remedies

We propose four comprehensive proposals to remove the inappropriate powers and restrictions and to align the interests of all key entities with individual and beneficial owners.

- Governments should affirm that creating an effective shareholder presence in all companies is in the national interest, that there should be no power without accountability and that this principle should be taken into account by all regulators, the Anti-Trust Department, the Takeover Panel, the competition authorities, stock exchanges, etc.
- All pension fund trustees and other shareholding fiduciaries must act solely in their beneficiaries' long-term interests for the exclusive purpose of providing them with benefits.
- To give full effect to the first two proposals, institutional shareholders should be made accountable for exercising their votes in an informed and sensible manner above some sensibly determined minimum shareholding (e.g. \$15m/£10m). Votes are an asset (voting shares always have a market premium over non-voting ones) which should be used to

- further beneficiaries' interests on all occasions. Thus the voting of all institutionally held shares would be virtually compulsory.
- To complete and powerfully reinforce the other three proposals shareholders should have the exclusive right to nominate at least three non-executive directors per major quoted company.

All four proposals are both necessary and mutually reinforcing. Government support for an effective shareholder presence is more than justified by the evidence that well-governed companies are both less risky and worth much more to shareholders and everyone else. With equities (directly and indirectly held) comprising the largest category of personal assets by far, the guarantor of decent retirement income, nothing less than effective accountability should be acceptable to the main political parties of both countries

Compulsory voting, solely in beneficiaries' interests, would prevent both passivity and automatic support of management proposals regardless of merit. As conflicts of interest will remain, particularly for fund managers, new investment institutions would arise without conflicts of interest to whom voting powers could be delegated. Further competent and cheap voting advisory services are widely available.

Audit committees of non-executives alone would recommend auditors (shorn of consultancy work) to shareholders, probably on rotation. (Managements would then seek consultancy help from other firms.) Pension fund trustees and other fiduciaries would appoint fund managers for typically 5 years plus (subject to safeguards). Remuneration committees, advised quite independently of managements, would provide generous but longer-term incentives, mainly in shares to be held for say 5 years.

The fourth requirement for shareholders to nominate at least three non-executive directors is essential to get indisputably independent accountability into the heart of every public company boardroom. The record of all too many failed and damaged companies shows that the truly appointment of independent non-executive directors - endorsed by *all* Anglo-American enquiries, commentators and the financial press - is far too important a matter to be left solely to executive directors with clear conflicts of interest. Nor would such shareholder nominated non-executive directors be a divisive presence. They would be concerned to show their colleagues that they were fully committed to the sustainable success of their company. The management appointed non-executives would be equally concerned to demonstrate that they too were independent in their conduct and judgments.

As with non-executives now, the great majority of such independent shareholder nominated directors would be chosen from the same pool of experienced businessmen and professionals. They would otherwise fail to attract sufficient support from individual or institutional shareholders. The crucial difference would be that they would be quite free of *any* implied obligations. Finally, the non-executives would have the power to insist on separate advice on significant takeovers and mergers and would give their recommendations to shareholders along with managements.

A quota of shareholder nominated directors is critical and long overdue reform. It ensures that shareholders can participate effectively in choosing of a critical mass of truly independent non-executive directors. All that our proposal does is to give substance to the oft-repeated claim '...that shareholders elect the directors.'

The removal of the six inappropriate powers that have gradually been acquired over many decades, longer-term appointments for fund managers, and longer-term management incentives would leave corporate managements free to concentrate on their prime responsibility, that of achieving sustainable longer-term performance for all individual and beneficial shareholders. The benefits to all the main participants would far outweigh the modest costs involved. All could continue prosper, but only if they genuinely benefited shareholders.

Critics may protest that our proposed modest catalytic government actions amount to creeping socialism, yet it is precisely the opposite. *Putting owners in charge of what they own is the purest form of capitalism.* If shareholder capitalism is to retain its legitimacy and regain unquestioned public support and confidence then government must play its indispensable role.

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The content of this article is largely based on the authors' recent books, Bob Monks', *The Global Investor*, and Allen Sykes' *Capitalism for Tomorrow* – both published by Capstone and reviewed in *Governance*.