

## **OVERCOMING THE COLLECTIVE FAILURES AT ENRON, MARCONI, ETC.**

**By Robert A G Monks and Allen Sykes**

---

Nick Land, UK chairman of Ernst & Young, has written a brave, balanced and timely article (*Times*, 28 February) on the recent failures in prominent American (and by implication British) companies. He catalogues widespread collective failure, including executive and non-executive directors, auditors, investment institutions, the wider financial markets, etc. and all their regulators. He fully acknowledges auditing failures and the profound implications for the whole profession. He accepts the need for accountants to understand the implications of recent events and be receptive to improvements in the system. He identifies 'total systemic failure' whereby all the checks and balances of corporate governance, financial market analysis, regulation and enforcement have been found wanting. While commenting primarily on Enron he accepts the implications apply equally to Britain as Marconi and numerous other companies attest. He could equally have mentioned the almost total recent neglect of good governance, and of market and regulatory scepticism, etc. in most failed Anglo-American 'dot.com' companies and numerous telecommunication companies.

Shareholder capitalism is not collapsing, but its widespread systemic weakness requires attention. The article thus prompts two major questions. First, what are the fundamental causes of the manifest weaknesses? Second, what are the effective remedies? The starting point for analysis, as it was the starting point for the article, is to recognise that all entities in the corporate process must accept individual responsibility for their actions within an acceptable system of protecting and serving society's interests. Given the collective systemic failure analysis must first consider the present system's checks and balances. All entities are meant to further society's interest as a whole, and particularly the longer-term interests of individual and beneficial shareholders. All entities, however, must necessarily respond primarily to their immediate paymaster, corporate management, and herein lies the main problem.

All the major system weaknesses and conflicts of interest arise from one fundamental malaise, the almost universal failure to discharge the ownership function in public companies. The desirable and government encouraged rise to dominance of institutionalised savings has relinquished to chairmen/CEOs and their executive colleagues 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 managements choose both their 'independent' non-executive colleagues and the auditors, i.e. the two main monitors for their shareholders. Managements also choose the remuneration consultants for the non-executive "independent" remuneration committee, nearly always their own corporate remuneration consultants. Managements 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. They exercise powers of patronage over other fund managers seeking their pension fund business and frequently part of groups wanting investment banking or insurance business. Finally, they avoid separate advice to non-executive directors on the merits of takeovers and mergers despite the frequent clash with shareholder interests.

Corporate managements and fund managers, however, also suffer serious unjustified restrictions. Fund managers, being judged over only 2-3 years, understandably 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

(the prime cause of the aggressive earnings management to which Nick Land refers) to the detriment of most investors with far longer-term horizons. Hence both managements and fund managers are also compromised, and prevented from playing to their longer-term strengths to investors' detriment. There has to be a better way for all parties.

All the compromised entities have prospered despite their inability fully to serve shareholder interests. Hence, despite a decade of reforms (stronger in Britain) the intended defences largely failed in numerous major Anglo-American companies through neglect of these inappropriate powers and restrictions. Effective reforms must deal with all of them.

There are four strong forms of evidence that neglected reform comes at a high price. First 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. Second, inability to control corporate managements causes institutional investors to shelter in very wide spread portfolios, yet committed owners with concentrated portfolios (e.g. Berkshire Hathaway) significantly outperform them. Third, the last 18 months show in selected industries and numerous mega companies that over-powerful corporate managements can massively destroy shareholder value. Fourth, a growing array of convincing studies (by McKinsey and many others) show that well-governed companies (including truly independent non-executives) significantly increase both value and stability. In sum, committed, knowledgeable, long-term ownership significantly raises corporate value.

Overcoming these weaknesses requires that the longer-term interests of all the main corporate entities are aligned to those of individual and beneficial shareholders. This necessitates **modest** catalytic government actions to set minimum standards and ensure compliance for society's benefit. Market forces could then respond to the changed requirements. Four proposals need enactment.

First, the government should affirm that creating an effective shareholder presence in all companies is in the public interest, that there should be no power without accountability and that this principle should be taken into account by all regulators, the competition authorities, stock exchanges, etc. Second, 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 (the existing but unenforced law). Third, 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 a sensible minimum shareholding (say £10m) always to be used to further beneficiaries' interests. (Competent and cheap voting advisory services are widely available.) Fourth, 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. Fund manager passivity would end either by their becoming directly pro-active for beneficiaries, or delegating their voting requirements to new investment institutions without conflicts of interest. Having a few shareholder nominated directors is a critical and long overdue reform. It would bring some reality to the oft-repeated claim 'that shareholders elect the directors 'by providing some non-executives without *any* implied obligations'. Such directors would still be largely drawn from businessmen and professionals, or shareholders (mainly the institutions) would not vote for them. Further, their very existence would promote greater independence in the management nominated non-executives.

The beneficial effect of independent non-executives would be considerable. Non-executive audit committees alone would recommend auditors (shorn of consultancy work) to shareholders, probably on rotation. Shareholders would readily accept any extra costs to ensure auditors with no conflicts of interest. Nor would there be any overall loss of work for accounting firms nor continuing doubts on their full independence. Independently advised remuneration committees would provide managements with longer-term incentives to match most investors' needs more closely. These might comprise generous share payments held for say 5 years. 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. Better value deals would result.

A final beneficial change would lengthen expected terms of fund managers the better to match most investors' needs.

Pension fund trustees and other fiduciaries would appoint fund managers for typically 5 years plus (subject to safeguards).

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 much better able 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 be very considerable and far outweigh the modest costs involved. All could continue prosper, but only if they genuinely benefited shareholders, particularly the majority saving for retirement. This is a crucial national requirement.

The modest government catalytic proposals would provide effective ownership of shares and would overcome all the presently entrenched main weaknesses, restrictions and conflicts of interest besetting Anglo-American shareholder capitalism. All the entities involved could again be confident of working in the public interest. The integrity of shareholder capitalism, and with it public confidence, would then be unquestioned.

1396 words

[Robert Monks is an American lawyer and investor activist and Allen Sykes a British businessman.]