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## 23. RECOMMENDATIONS AND LESSONS FROM THE EVENTS

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### Introduction

- 23.1 Although we submitted some preliminary recommendations to the Secretary of State for Trade and Industry in 1995, we have reviewed the position in the light of the considerable developments that have occurred since then. We are grateful to the Financial Services Authority (FSA), the Occupational Pensions Regulatory Authority (Opra), the Department of Social Security (DSS), the Department of Trade and Industry (DTI) and the Institute of Chartered Accountants in England and Wales (ICAEW) for discussing with us a number of issues that we consider arise in the light of the events we have investigated.
- 23.2 The most important lesson to be learnt is that high ethical and professional standards must always be put before commercial advantage. The reputation of the financial markets depends on it. Legislation and regulation is, however, of great importance in underpinning those standards.
- 23.3 Many of the deficiencies in legislation and regulation which permitted the events we have described to occur have been rectified, but there remain some important matters which still require to be addressed or considered. We deal with these under the following headings:

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(3) Regulation within the UK	23.31 – 23.43
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### (1) Pensions

- 23.4 In February 1995, we put forward some preliminary recommendations in relation to pensions in the light of the fact that the Pensions Bill, based on the full and comprehensive report of the Pensions Law Review Committee chaired by Professor Sir Roy Goode QC<sup>a</sup> (the Goode Committee), was then before Parliament. We have since that time considered the resulting Act and had the benefit of discussions with Opra.

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<sup>a</sup> Cm 2342. It was followed by a White Paper “Security, Equality, Choice: The Future for Pensions” (Cm 2594)

23.5 The Act and the Regulations made under it has prohibited many of the abuses we have identified<sup>a</sup> such as the provision of loans to the employer, provided effective sanctions for the late completion of accounts<sup>b</sup> and provided duties to “whistle-blow”<sup>c</sup>.

**(a) The risk of misuse and public expectations**

23.6 Although the changes to the law made by the Pensions Act 1995 and the creation of the regulatory regime under the supervision of Opra have made it less likely that pension funds will in the future be misused, the risk cannot be eliminated as no system of regulation can do so, particularly when there are about 119,000 “live” occupational pension schemes, most of which are very small. This is a risk which must be understood by the public. Vigilance by associations representing beneficiaries to ensure they are provided with full information and disclosure<sup>d</sup> can be an effective prevention against abuse and mismanagement.

23.7 We understand that there has been a good response to the duties imposed under the “whistle blowing” provisions contained in Section 48 of the Act<sup>e</sup>. However, as pensions are such a significant asset for most of the population, there are in our view some further modest steps that should be taken, at little cost, to reduce the risk further.

**(b) The trustees**

23.8 As it is the trustees of each pension fund under the UK system who remain central to the proper stewardship and investment of pension funds, it is upon them that the beneficiaries must primarily depend for the proper care and management of their pensions arrangements. It is therefore essential to encourage suitable people to become trustees and give them proper support in discharging their onerous responsibilities.

23.9 We consider that the work done by Opra and the DSS in raising the standards expected of trustees, providing them with guidance<sup>f</sup> and in encouraging education and training is greatly to be welcomed; the provision of guidance and encouragement of training is remedying one of the serious deficiencies that existed.

23.10 The statutory objectives of Opra do not, however, include an obligation to give information and guidance, though this has not inhibited them from doing so. In view of the central importance of this function to the proper running of pension trusts, we recommend that the Act should be amended, when the occasion arises, to add this as an objective. There may be cost implications, but we doubt

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<sup>a</sup> See the summary at paragraph 22.7.

<sup>b</sup> cf paragraph 13.4.

<sup>c</sup> cf paragraph 22.11.

<sup>d</sup> cf the attempts to get information by the pensioners of MGPS described at paragraphs 6.22 and 13.38.

<sup>e</sup> cf the position under section 109 of the Financial Services Act 1986 referred to in the footnote to paragraph 5.43.

<sup>f</sup> Opra published in July 1997 “A Guide for Pension Scheme Trustees” which is intended to help trustees understand their duties and responsibilities.

whether these would outweigh the benefits obtained by providing further assistance to trustees who perform such useful and important functions.

23.11 As trustees take on such an onerous responsibility, they should be given every assistance in carrying out their responsibilities particularly in dealing with their professional advisers. We recommend that in addition to the valuable work done by Opra and the DSS, there are some further steps that should be taken:

- **Guidance on good practice:** We consider that the clear and helpful guidance published by Opra on the duties and responsibilities of trustees should be expanded to include more detailed guidance on relations with auditors<sup>a</sup>, custodians, legal advisers, actuaries, investment managers, financial advisers and independent scheme administrators. These are the key professionals upon whom the trustees are dependent. This guidance should cover the minimum information that they should require from each adviser and the kind of probing questions they should ask. It should also set out what trustees can expect from their advisers and what they cannot and must check themselves. It is in our view important that there should be a clear understanding of the respective roles of trustees and their advisers. We understand that Opra are in the process of preparing guidance in relation to some of these professionals.
- **Model terms of engagement with professional advisers should be provided by Opra:** Although we recognise that trustees must be free to negotiate with their professional advisers on the exact terms of their engagement, there are certain points which as a matter of good practice should always be covered. For example, model terms of engagement with auditors could provide for an annual report on internal controls and the custody of assets (if appropriate) and for the attendance of the audit partner at least once a year to present a report to the full body of trustees. It may also be desirable that guidance be given on the disclosure of the fees paid to professionals, as there is public interest in controlling the costs that pension schemes have to bear.
- **Related party transactions:** All pension trust deeds should contain a requirement that all proposed related party transactions should be put before the full body of trustees for consideration and approval. We recommend consideration be given to legislative provisions to facilitate this.
- **Training for trustees:** The Goode Committee considered it was impracticable to require all trustees to attend training courses<sup>b</sup>. However bearing in mind the onerous responsibilities placed on trustees and the fact that few non-professionals have little relevant experience on

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<sup>a</sup> Opra published in June 2000 “A Guide to Audited Scheme Accounts” for people involved with insured salary-related pension schemes. It contains helpful guidance on what the trustees must do themselves and what they can look to professional advisers to provide. In October 2000, Opra published “A Guide to appointing professional advisers”. This again contains very clear and useful practical guidance on how to appoint (and dismiss) professional advisers.

<sup>b</sup> Recommendation 52. See also paragraph 4.5.65.

appointment, it ought to be regarded as standard practice that trustees are trained; they need to know not only their responsibilities and have the skills necessary to invest the assets of the fund, but also how to question apparently plausible explanations put forward by professional advisers. We understand that consideration is being given by the DSS to requiring trustees to make a statement in their annual report on their training policies; this is a welcome and necessary step forward towards universal training.

**(c) The professions**

- 23.12 We were surprised to discover a lack of understanding by some professionals of the fiduciary duties relating to pension funds<sup>a</sup>. There can be little doubt that advising and auditing pension funds requires specialist knowledge and skill. It should be a clearly expressed and specific part of the code of conduct of each relevant profession that those advising pension funds have a duty to familiarise themselves with the relevant fiduciary duties<sup>b</sup>. This should prove a relatively cost efficient way of bringing home to professionals this obligation in contrast to a licensing system or certification of special training requirements. The relevant government departments responsible for the professional bodies should ensure that the necessary changes are implemented.

**(d) The Disclosure Regulations**

- 23.13 In February 1995 we put forward some preliminary recommendations relating to proper disclosure in pension fund accounts of material transactions, and in particular related party dealings, during a scheme year. The basis of these recommendations was that disclosure has a preventative effect. Since that time a revised SORP entitled “Financial Reports of Pension Schemes” and Financial Reporting Standard (Number 8) entitled “Related Party Disclosures” have been issued. These require proper disclosure of related party dealings in pension fund accounts.

**(e) The regulator – Opra**

- 23.14 It would be clearly impracticable and incompatible with a system based on the use of a very large number of non professional trustees to require them to be vetted and approved prior to appointment. At present the powers of Opra in respect of trustees are somewhat limited.
- 23.15 Opra should be given power to prohibit individuals acting as trustees if they discover evidence that shows they do not meet “the fit and proper” standard, despite the limitations to which we refer at paragraph 23.39.

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<sup>a</sup> See paragraph 5.42.

<sup>b</sup> Some professions have general rules: see for example Section 1.200 of the Guide to Professional Ethics of the ICAEW. This provision was in force during the period of the events we describe. The Auditing Practices Board issued in 1997 a Practice Note (Number 15), “The audit of occupational pension schemes in the United Kingdom”, which replaced the Auditing Guideline ‘Pension Schemes in the United Kingdom’ which was issued in November 1988 and was extant during the period of the events we describe. The Practice Note contains explicit statements that auditors need to be familiar with the legal and regulatory background to pension schemes.

**(f) Custodianship**

- 23.16 A significant proportion of the shares of the pension funds that were used as collateral for bank loans to the private side were in the custody of a custodian of high reputation<sup>a</sup>. However under the usual form of custody agreement, the custodian is entitled and obliged to act in accordance with instructions given to him provided they are duly authorised, without enquiring into whether the action authorised is in the proper interests of the pension funds. In many senses therefore, it follows that entrusting assets of a pension fund to a custodian provides little more protection to the assets of that pension fund than could be obtained by placing them in a safe and controlling access to the key (in the same way as controlling the authority to give the custodian instructions<sup>b</sup>). Pure custodianship is therefore of limited value in preventing any misuse of pension fund assets. We agree in this respect with the conclusions of the Goode Committee<sup>c</sup> that it would not be appropriate to require trustees to place pension fund assets with independent custodians<sup>d</sup> under the usual form of custody agreement. Mr Paul Myners<sup>e</sup> in his letter to the Chancellor of the Exchequer and Secretary of State for Social Security dated 8 November 2000 has indicated that he intends to recommend that it be a mandatory requirement that assets be placed in the possession of a regulated custodian independent of the employer. Mr Myners' review considered that matters had changed since the time of the Goode Committee's Report and, in particular, custodians are now authorised and discussions with the pension fund industry suggested that the costs involved were not likely to be significant, as the custodian will ordinarily perform ancillary services at a lesser cost than the pension administrator could provide them. Mr Myners' review also considered that independent custodians could provide a source of independent "check and balance", raising questions about unusual transactions even if not legally obliged to. This proposal is, we understand, made in the context of expecting greater professionalism from trustees, making them more accountable and imposing on them a higher legal duty in respect of their decision making. If it is envisaged that a custodian will perform services ancillary to pure custodianship and will undertake a higher legal obligation in respect of the propriety of instructions than that which is presently found in the usual form of custody agreement, then we see merit in the proposal.
- 23.17 As is mentioned at paragraph 5.37, in the USA the obligations placed upon custodians under ERISA may be more onerous, as a custodian who is regarded as a fiduciary is in effect required to monitor compliance with pension plan trust deeds and must act in accordance with strict fiduciary standards. This form of custodianship is more akin to a professional trustee of a pension fund in the UK and would in essence duplicate at a cost the work done by the trustees under UK pension funds. Given the fundamental policy decision made in the 1995 Act to continue to rely upon the central role of the actual trustees in the proper stewardship and investment of each pension fund (following the

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<sup>a</sup> See paragraph 5.33.

<sup>b</sup> This was accepted by the custodian which held some of pension fund shares – see paragraph 5.33.

<sup>c</sup> Recommendation 114

<sup>d</sup> We do, however, consider that the involvement of independent custodians does give an opportunity for whistle blowing although this may be limited due to the nature of the custodians' obligation.

<sup>e</sup> He is Chairman of Gartmore Investment Management, fund managers. He was requested by H M Government to carry out a review of institutional investment.

recommendations of the Goode Committee), the wider form of custodianship is presently inappropriate in the UK.

**(2) The public offering of securities**

23.18 In July 1995, we put forward some preliminary recommendations in respect of changes<sup>a</sup> that should be considered in the role of the Stock Exchange and advisers in relation to listing of new securities; we also suggested changes to the Yellow Book, after discussions with those then responsible at the Stock Exchange (which was then the UK listing authority).

23.19 On 1 May 2000, the functions of the Stock Exchange as the UK listing authority were transferred to the FSA. It is therefore not necessary for us to set out what changes we previously considered needed to be made in the internal procedures of the Stock Exchange in the light of its own internal report on the MGN flotation and the subsequent changes to the Yellow Book. Significant improvements were made to those procedures when the Stock Exchange was the UK listing authority. We have discussed with the FSA the issues that we consider still remain to be addressed.

**(a) The expectations gap on the role of the UK listing authority**

23.20 As set out earlier in this Report, there was some confusion as to the Stock Exchange's role and responsibilities<sup>b</sup>; for example, many (including leading figures in the City) told us that they regarded it as significant that the Stock Exchange had permitted RM to become the chairman of a public company, whereas the Stock Exchange told us it had no power to prevent him<sup>c</sup>. A misconception of the role of the listing authority can lead investors to attach undue significance to the actions or inactions of the listing authority.

23.21 The public is, in our view, entitled to a simple statement of the role and responsibilities of the UK Listing Authority so that its limited regulatory function is clearly understood. This should cover:

- Its understanding of its duty as the listing authority as regards the accuracy and completeness of a prospectus.
- The fact that it does not regard itself as under any responsibility as to suitability for listing of a company being listed.
- Its understanding of its very limited responsibility in respect of the directors.

One way of doing this is to build on the passage contained in the introduction to the current Listing Rules (the "Purple Book").

**(b) A definition of the role and duties of advisors on a flotation**

23.22 In 1978 the Council for the Securities Industry proposed the formulation of a Code of Conduct in relation to flotations and other new issues<sup>d</sup>. It met powerful opposition in the City and the work was

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<sup>a</sup> We also drew attention to the view expressed to us about future flotations of companies owning newspapers, as set out in paragraph 17.7.

<sup>b</sup> See paragraphs 7.17 to 7.19.

<sup>c</sup> See paragraphs 1.15, 4.5 and 4.36.

<sup>d</sup> See the footnote to paragraph 7.2.

never finalised. This was unfortunate as the expressions of concern by persons such as Lord Benson were ignored and the opportunity missed to record the lessons to be learnt from corporate failures so that they were available to those who by reason of their youth or inexperience had not encountered them; they summarised their concerns as follows:

“there should be a general requirement that those sponsoring public issues should form an overall opinion whether those running a private company are fit to run a public company. A prospectus may contain no misstatements and may yet give a wrong general impression. An entrepreneur may run a private company very successfully as a one-man show, but be unwilling or unable to submit to the disciplines, in regard to accounts, board meetings etc required in a public company.”

23.23 We recommend that the unfortunate rejection by the City of such a code should now be remedied. We recommend that the FSA should facilitate the production of “Guidance” setting out a statement of the respective duties and responsibilities of advisers<sup>a</sup> and containing useful advice and examples of lessons that have been learnt.

**(c) Box ticking**

23.24 Regulation can give rise to a real risk of a “box ticking” approach. This is less of a risk where broadly based codes are used which are not prescriptive, as such codes encourage the exercise of judgment rather than a mechanical approach. An example of the risk to which we refer is that, if there is a requirement for an audit committee under a code or regulation, then the obligation can be taken as performed by establishing one, without ensuring its proper organisation and integration into the overall structure of the company<sup>b</sup>. The “Guidance” we have proposed should therefore emphasise that, although compliance with the detailed requirements must be thoroughly performed, advisers have not fulfilled their duty unless they stand back and analyse the issues and the solutions to see whether at the end of their task the intended result has been achieved.

**(d) Disclosure**

23.25 The tendency has been for listing particulars to become increasingly long. This has been accentuated in part by a properly cautious attitude to disclosure displayed by advisers. However there is an increasing risk that, although everything is in fact disclosed in detail, it is not easy to discern a fair presentation of the risk attendant in subscribing to the shares. We do not think providing for less disclosure or for a short form prospectus would be the answer, but the issue needs to be addressed.

23.26 We therefore recommend that consideration should be given to requiring directors to include in the particulars a summary “fair presentation” of the risks and benefits of subscribing to the shares; a fair presentation would require a degree of candour as it would have to draw to the attention of investors not only the specific advantages on the upside but also the specific disadvantages on the downside<sup>c</sup>. There are some powerful arguments against such a “fair presentation”, but this is an issue that should be debated and considered.

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<sup>a</sup> We have set out in Appendix 10 a summary of the functions and duties of advisers in 1991.

<sup>b</sup> cf what happened on the flotation of MGN: see paragraphs 10.31, 20.72, 21.72 and 22.19.

<sup>c</sup> cf the evidence of Samuel Montagu set out at paragraph 17.13. If a “health warning” had to be given, the conclusion might be that the company was not suitable for listing.

**(e) Listing requirements**

23.27 In July 1995, we made preliminary recommendations that there be changes to the Yellow Book to cover:

- The application of the rule relating to continuity of management to non-executive directors<sup>a</sup>.
- More detailed requirements in relation to the pension fund<sup>b</sup>.
- More stringent listing requirements in relation to financial controls<sup>c</sup>.
- A requirement that the financial position of a shareholder with a controlling interest be disclosed<sup>d</sup>.

23.28 The last of these points appears largely to have been met by the requirement in the “Purple Book”<sup>e</sup> that the listing particulars contain a statement explaining how the issuer is satisfied that

- (a) it is capable of carrying on its business independently of the controlling shareholder; and
- (b) all transactions between the issuer and the controlling shareholder are and will be at arms’ length and on a normal commercial basis.

As to the other preliminary recommendations:

- We understand that the rule as to continuity of management has been relaxed to facilitate the listing of companies; whilst we appreciate the reasons for this, it imposes a higher duty on the sponsor to satisfy himself that the company is suitable for listing and a clear duty to disclose prominently in the prospectus any lack of continuity<sup>f</sup>.
- We also understand that recent practice has been to disclose more about the arrangements for pension funds; we do not consider it is sufficient just to rely upon practice.

We therefore recommend that the listing rules be changed to make more detailed requirements in relation to both pension funds and financial controls.

**(f) Reporting accountants**

23.29 The Auditing Practices Board produced in December 1997 “Statements of Investment Circular Reporting Standards” which considered independence and ethical standards where a firm that is the auditor to a company acts as reporting accountants to that company. These statements require<sup>g</sup> that

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<sup>a</sup> See paragraphs 10.23, 10.24, 22.19 and 22.25.

<sup>b</sup> See paragraphs 22.46 to 22.50.

<sup>c</sup> See paragraph 22.36. A new rule (Para 2.11) was introduced into the Listing Rules in December 1993 to deal with financial reporting procedures.

<sup>d</sup> See paragraphs 19.11 and 22.63 to 22.66.

<sup>e</sup> Listing Rule: Para 3.12, 3.13 and 6.C.23.

<sup>f</sup> Paragraph 3.8 of the Listing Rules requires the directors and senior management to have collectively appropriate expertise and experience.

<sup>g</sup> SIR 200 – Accountants’ reports on historical financial information in Investment Circulars, paragraph 8.

where an opinion in true and fair terms is involved, a partner other than the audit partner should be involved in the conduct of the work<sup>a</sup>.

23.30 In our view this does not go far enough, given the essential role of the reporting accountant in the due diligence work done on a public offering. It should be a minimum requirement (and not a recommendation) that the team be completely independent of the audit team of the company being reported upon and any other company controlled by the majority shareholder. However best practice that should be required by sponsors, unless there are strong reasons to the contrary, should be that the reporting accountants come from another firm so that a completely independent view is provided.

**(3) Regulation within the UK**

23.31 There were significant changes, particularly at IMRO after November 1991<sup>b</sup>. The establishment of the FSA in late 1997 has brought about much needed radical change. One of the most significant changes has been to reduce within the UK the fragmentation of regulation that was one of the hallmarks of the 1986 Act. The implementation of the Financial Services and Market Act 2000 (FSMA) later in 2001 will further strengthen the changes. There are, however, five matters on which we now wish to comment.

**(a) Conflicts of interest**

23.32 The approach to regulation adopted by the FSA is one of prudential supervision of each firm regulated; the aim is, having regard to business of the firm, to ensure the adequacy of the firm's capital and the systems and controls which the firm has in place to prevent wrongdoing and breaches of regulation. Wide use is made of individual registration so that individuals appreciate the personal responsibility they carry and the sanctions that can be visited on them personally. The FSA assesses the systems and the calibre and integrity of the management and expects firms and individuals to report breaches and to whistle blow. It also adopts a pro-active approach, for example by checking on individuals, carrying out visits and investigations at firms' premises, examining any complaints made about firms, analysing relationships with customers and overseeing what is happening in the market.

23.33 Even allowing for the FSA's pro-active approach, this method of prudential supervision, which depends to a significant extent upon member firms to enforce proper regulation through proper systems, must also manage the conflicts of interest that are produced by this regulatory method. We welcome the very strict and rigorous stance the FSA has taken on this issue.

23.34 It must, however, be appreciated that there remain therefore considerable risks in this system of regulation because of the inherent conflict that exists between (1) the desire of a firm on discovering wrongdoing to protect its own financial position by making recoveries of monies outstanding and avoiding damage to its own commercial reputation by keeping the discovery confidential and (2) the

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<sup>a</sup> Samuel Montagu had stipulated that the partner in charge of the reporting accountants' team was to be a person who had not been involved in the audit of MGN for the preceding five years (see paragraph 4.17).

<sup>b</sup> See Appendix 9, paragraphs 7.1 to 7.10.

public interest in immediate disclosure to regulators and in taking action against the malefactor with the consequent adverse publicity to the firm and the reduced chance of making recoveries. This conflict can only be met by vigilance on the part of the FSA and by severe and public deterrent penalties against not only the individual who has failed to honour his obligations but against the senior management of companies where there is a failure to whistle blow or disclose wrongdoing. It should be made costly in terms of loss of reputation to fail to disclose wrongdoing and to attempt to cover it up, if the FSA's system of prudential supervision is to command public confidence in the long term.

**(b) The expectations gap on the scope of regulation**

- 23.35 Regulation plays an essential role in maintaining public confidence in institutions that are permitted to handle and invest pensions and savings. However, no system of regulation can prevent another series of events similar to that surrounding RM's companies, though the risks of this happening should have been significantly reduced by the radical changes made to the regulatory regime by the FSA and the FSMA. The public should understand the risks. There should be no "expectations gap" and the fact that an institution is approved and regulated does not obviate the need for vigilance.

**(c) Approval of a person as fit and proper**

- 23.36 A clear example of the fact that regulation is not an assurance against wrongdoing is provided by the limitations on the scope that a regulator has for declining to approve a person as a fit and proper person to conduct investment business.
- 23.37 As is clear from our summary of the events leading to the approval of BIM as an investment manager, a forcible view was expressed about the integrity of RM<sup>a</sup>, but BIM was nonetheless approved as the view was taken that there was no hard evidence to support a refusal to admit BIM<sup>b</sup> which would withstand scrutiny in court.
- 23.38 After the events we have described, IMRO introduced a system<sup>c</sup> of individual registration which the FSA will also implement. In June 2000 the FSA published "High level standards for firms and individuals" which contained as annexes "Statements of Principle and Code of Practice for Approved Persons" and "Fitness and Propriety". These set out the standards which it is expected the applicant must meet and maintain; if an individual fails to maintain standards and is disciplined, he may not be employable in the industry. We consider that this more robust approach<sup>d</sup>, together with improvements in the gathering of information, go a substantial way to remedying the difficulties.
- 23.39 However, we do not consider that the basic problem has changed. The FSA cannot act without hard evidence which will withstand scrutiny in court. Thus an approval is more in the nature of a negative

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<sup>a</sup> See paragraph 5.6.

<sup>b</sup> See Appendix 9, paragraph 2.6.

<sup>c</sup> See Appendix 9, paragraph 7.6.

<sup>d</sup> See also the approach adopted by IMRO after 1993 described in Appendix 9, paragraph 7.3.

clearance than a positive approval. The public should have a clear understanding of this; there should be no expectations gap.

**(d) The communication of information**

23.40 The inclusive structure of the FSA, the ending of the fragmented system of regulation created by the Financial Services Act 1986, the establishment of a department of the FSA to deal with complex groups and the transfer of supervision under the Banking Act 1987 to the FSA has meant that the problems of communication of information within the UK are now significantly less.

23.41 We understand that since the events we describe the information exchange network established in 1992 as set out in the footnote to paragraph 6.43 has continued to expand and now has a full time secretariat and membership includes such bodies as the DTI, the FSA, the SFO, the Stock Exchange and Opra as well as a number of other regulatory organisations in the widest sense.

**(e) Staffing of regulatory bodies**

23.42 We have noted<sup>a</sup> views expressed to us about the comparative inexperience of the regulatory staff who conducted the inspections of BIM. We understand that the knowledge and experience of staff is now much better, though the retention of staff with experience sufficient to conduct an analytical review of a firm remains a challenge.

23.43 It is in the general interests of regulated firms that the public has confidence in regulation as it underpins confidence in their business. It is therefore in their own interests to make available on secondment their more able employees to ensure that regulators obtain staff who have the relevant experience of current market practices. We would encourage the FSA to make public information about the assistance given to them by firms through the provision of seconded employees. City firms and institutions should do as much as possible to see secondment to a regulator as an important step in the career of their most able employees.

**(4) The securities markets**

23.44 The dealings in MCC and MGN shares exemplify problems that have arisen in markets in securities because firms who deal in securities operate in markets on a transnational basis whereas regulation of markets to ensure that they are fair, open and transparent is essentially still national. This therefore gives rise to issues on which more radical thought is needed.

23.45 For example, a transnational firm can choose the regulatory regime that best suits a particular transaction and conduct business in such a way that others in the market do not have a clear picture of what is happening<sup>b</sup>. Although individual exchanges monitor what is happening on that exchange and there is co-operation between exchanges, there is no overall monitoring of transactions in the same security done in different markets or through different subsidiary companies of the same firm operating under different regulatory regimes. For example, although a subsidiary of a transnational

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<sup>a</sup> See Appendix 9, paragraphs 5.13 and 6.4. For the changes at IMRO after 1991, see Appendix 9, paragraph 7.5.

<sup>b</sup> See paragraph 1.12 of Appendix 7.

firm authorised in the UK is required to report all trades undertaken in a security to the FSA regardless of the location of a trade or whether it is on or off market, there is no obligation for a subsidiary not authorised in the UK to do so; that subsidiary reports to the regulator in the state which regulates it<sup>a</sup>. Thus the transnational firm has a very substantial advantage over national governmental regulators which attempt to regulate its transactions in a given security to ensure that markets are fair, open and transparent; it is not in the public interest that this imbalance should continue as it can, as the dealings in MCC and MGN shares exemplify<sup>b</sup>, be detrimental to the maintenance of fair, open and transparent markets. More effective control and accountability is therefore needed over the business transacted by the transnational firms to ensure the openness, fairness and transparency of markets in securities. As has been forcibly pointed out, this is a matter of wide public concern and interest, given the dependence of large parts of the population on the investment of their savings and pension funds in securities traded in these markets<sup>c</sup>.

23.46 Much of the debate on transnational regulation has taken place in the context of controls over systemic risk to international financial stability and in the context of greater access to markets. It is, we believe, important that the debate also gives sufficient emphasis to the need for control over transnational firms to ensure fair, open, transparent and stable markets in which the public and investors can have confidence.

**(a) Co-operation under existing arrangements**

23.47 Arrangements exist for the exchange of information between regulators in different jurisdictions and for the obtaining of information from other state authorities both in the UK and overseas:

- Within the European Economic Area EC Directives<sup>d</sup> form the basis of co-operation and set out the terms on which information can be exchanged, used and disclosed within the European Economic Area and to states outside that area. The implementation of the Directives has not been entirely uniform and differences exist in national implementation.
- There are also other bilateral and multilateral arrangements<sup>e</sup>, usually in the form of a “Memorandum of Understanding”, which facilitate co-operation. These arrangements specify the terms on which information can be exchanged and used, including restrictions on disclosure even as between different regulatory authorities with the same state<sup>f</sup>. This is a regime of “soft

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<sup>a</sup> The monitoring system operated by the FSA is in addition to that carried out by the Stock Exchange in London; for example, the Stock Exchange monitors compliance with closed periods.

<sup>b</sup> See our conclusions at paragraph 22.82 to 22.92 and Appendix 7.

<sup>c</sup> The FSA has adopted a broader approach to its jurisdiction and will exercise jurisdiction over actions overseas if they have an effect in the UK.

<sup>d</sup> These include the Major Shareholding Directive, the Insider Dealing Directive, the Investment Services Directive, and the Second Banking Consolidation Directive. Liechtenstein is a party to the European Economic Area Agreement which extends to the European Economic Area the operation of single market directives.

<sup>e</sup> There is also an Intermarket Surveillance Group which includes all the Exchanges in Canada and the US as well as Amsterdam and Brussels, but not Paris or Frankfurt; this is a group of self regulatory organisations. At present the FSA and the London Stock Exchange are members of it. When the FSA becomes a statutory regulator, then the information will have to be supplied to it through the SEC.

<sup>f</sup> For example, a memorandum of understanding between the DTI, the Securities and Investment Board and the Swiss Federal Department of Finance contains restrictions on the disclosure of information.

law” which is not enforceable or legally binding. This regime is subject to national laws and, within the European Economic Area, to the EC Directives.

- In 1999, the FSA and the 16 other members of the Forum of European Securities Commissions (FESCO) signed a Memorandum of Understanding on the Exchange and Surveillance of Securities Activities; this provides a multilateral framework for the sharing of information about business in the securities markets undertaken by firms within the European Economic Area and for bilateral co-operation<sup>a</sup>. However, the initial report of the *Committee of Wise Men on the Regulation of European Securities Markets* under the chairmanship of Mr Alexandre Lamfalussy (the initial Lamfalussy Report) concluded<sup>b</sup>:

“However useful this work is, FESCO is confronted with several drawbacks: it has no official status, it works by consensus and its recommendations are not binding. Furthermore, the actual implementation of those decisions in different Member States is dependent upon the regulatory powers granted internally to each respective regulator – and these differ widely.”

23.48 The system for the exchange and obtaining of information has at least three limitations:

- It is usually reactive and does not easily permit routine monitoring to ensure that the market has all the relevant information, although proactive exchange of information is permissible
- It can be slow, as a request for information has to be made and then a response considered. Some jurisdictions are quicker than others; for example the Memorandum of Understanding between the UK and the USA and the FESCO Memorandum of Understanding provide for urgent requests.
- Some jurisdictions prohibit the making public of information so obtained<sup>c</sup>. As the provision of information to the public as to the way in which a market is operating or has operated is often the most effective sanction against the wrongdoer, this is a serious restriction in such circumstances, though there are other circumstances (such as criminal investigations) where restrictions can be necessary.

The initial Lamfalussy Report observed more generally in respect of the EU:

“There is no single template for supervision. Co-operation between securities regulators for dealing with cross-border practices and trading is only lightly covered.”

**(b) International lead supervisors and colleges of regulators**

23.49 Steps are, however, being taken to establish the principle that, in supervising financial groups active in a number of industry sectors, it is helpful to have a co-ordinating supervisor operating on a transnational basis.

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<sup>a</sup> In June 2000 FESCO produced a paper (FESCO/00-0961) to contribute to the consideration by the EU Commission in formulating a Directive on market manipulation. This paper suggested that “the Directive must do more not only to enhance co-operation between supervisors... but also establish a more common approach to detection and investigation... as well as enforcement”.

<sup>b</sup> 7 November 2000.

<sup>c</sup> It has been observed to us that jurisdictions with highly pervasive freedom of information rules can also pose difficulties in exchanging information.

23.50 For example the FSA has regular bilateral meetings with other European Regulators, particularly those in France, the Netherlands, Germany and Sweden. It has also encouraged the establishment of international colleges of regulators; for example with regard to banking supervision, it has regular meetings with the Federal Reserve Bank of the United States and the Swiss Banking Commission to co-ordinate supervisory programmes. IMRO, the SEC and the Securities & Futures Commission of Hong Kong collaborate on joint visits to head offices of transnational firms with local visits based on a common agenda. We welcome this approach.

**(c) Possible longer term solutions**

23.51 Other solutions in relation to issues are being addressed. For example the theme of the International Organisation of Securities Commissions (IOSCO) annual conference in May 2000 was “Global Markets, Global Regulation”. It was recognised that it is impossible to regulate investment activity on a nation state basis, but progress in solving the difficulties created is clearly very difficult. Possible ideas include:

- Regulation by the home state of the transnational firm: Within the EU, a firm regulated in the home state has a “passport” to conduct similar business throughout the EU and is primarily regulated by the home state. This could be expanded gradually to a global framework, giving the home state power to compel all the subsidiaries of the firm to report to it on all business done, whatever the jurisdiction in which the business was effected. However, given the global dominance by a few firms from a small number of states, this would have considerable political implications and be difficult to achieve without a common approach to a legal framework. Furthermore such a system requires a common regulatory approach on methods of supervision and risk assessment and common standards on matters such as solvency and exposures; that would not be easy to achieve given different national perspectives.
- Supervisory regulation of an individual security from its home base. To ensure that there was proper information about the dealings in a particular security, a national exchange or regulator could be designated as the body to whom dealings in the security had to be reported; the home state for this purpose could be, for example, the state of the corporate residence of the issuer or a state chosen by the issuer. This would not be an easy system to operate; the choice of home state would at times be difficult and dealings in shares can move from market to market. Furthermore, account would have to taken of the implications arising from the fact the Stock Exchanges now compete with each other and some regulate new electronic markets which are their competitors.
- Development of the system of international lead supervisors and colleges of regulators: we have described the steps being taken to develop this system. For the foreseeable future, this may well be the only system which will be practicable<sup>a</sup>.

23.52 We appreciate the very real difficulties that lie ahead, but this is a problem that is of considerable importance to the public the value of whose savings and pensions depend on the proper operation of

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<sup>a</sup> The Final Report of the *Committee of Wise Men on the Regulation of European Securities Markets* published on 15 February 2001 recommends the setting up of an EU Securities Committee and an EU Securities Regulators Committee. They conclude “Other options are in the present circumstances impractical, including a single European regulatory authority.”

the markets in securities. We can do no more than draw attention to the need for these issues to be a matter of high priority in that context for further consideration and action. The events relating to the dealings in MCC and MGN shares demonstrate vividly the abuse of the market that can arise; since those events the progress towards globalisation has increased and the growth in the use of the internet have increased the opportunities for market manipulation<sup>a</sup> and made the problems of national regulation even more difficult.

**(d) Jurisdictions where there is secrecy**

- 23.53 Another problem that arises in the transnational markets in securities is the use in the course of trading of jurisdictions where little information is publicly available about the beneficial ownership of corporate entities, trusts, foundations or other entities. In some jurisdictions, it is even possible for lawyers, bankers and other professionals to refuse to reveal the identity of a client for whom they have purchased securities without the consent of that client. There can be legitimate reasons for such confidentiality, but there can be no justification for withholding information about ownership from regulators in other jurisdictions when they are concerned about the operation of markets in other jurisdictions, even if the regulator may make that information public.
- 23.54 A proper application of the “know your customer” rule by securities firms should go some way to obviating the difficulties; they should, as part of that rule, in appropriate circumstances ascertain the ultimate beneficial ownership of the counterparty with whom they were dealing. We have no doubt that some jurisdictions which still maintain secrecy laws will be persuaded to change their attitude; the publication by the Financial Stability Forum<sup>b</sup> and the Financial Action Task Force on Money Laundering<sup>c</sup> of standards in different jurisdictions has highlighted the different quality and level of co-operation given by offshore centres and compliance with acceptable standards. In the case of those jurisdictions which do not co-operate, then we would suggest that consideration be given to taking steps to restrict dealings by securities firms in securities that are traded with any person in such a jurisdiction unless that person makes a declaration of the ultimate beneficial ownership of the securities the subject of the transaction.

**(e) Public expectation of regulation**

- 23.55 It is obvious from the above that protection by national regulators of the public in their dealings on markets is of less effect than it was before the advent of global markets and the transnational firms that deal across those markets. It is therefore very important that the public appreciates this fact and that as globalisation increases, so the level of protection afforded by national regulation of markets gets less.

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<sup>a</sup> See for example the report of the Technical Committee of IOSCO on Investigating and Prosecuting Market Manipulation, May 2000. It identifies common types of manipulative methods that can be used to create a false market and gives several examples.

<sup>b</sup> See <http://www.fsforum.org>.

<sup>c</sup> 22 June 2000: see <http://www.oecd.org/fatf>; some of FATF's 40 recommendations might provide a useful basis for standards applicable to transnational dealings in securities, in particular recommendations 8 to 12.

23.56 This fact underlines the importance of progress to more effective transnational supervision of markets to ensure their fair, open and transparent conduct and of the transnational firms that operate in them to correct the imbalance that presently exists to the detriment of the proper operation of the markets.

**(5) The audit and regulation of company “empires”**

23.57 RM’s companies were made up of several different groups of companies (in the technical sense); as there was no overall group, there was no requirement for an overall audit of the companies he controlled, despite the fact that RM operated those companies as one “empire”, using that term to distinguish it from the technical sense in which “group” is used. The position of that “empire” was exacerbated by the opaque ownership structure which included offshore vehicles and the fact that many companies had different year ends<sup>a</sup>.

23.58 We have expressed the view<sup>b</sup> that the auditors would have been able to obtain a somewhat clearer view if there had been one partner with an overview of the “empire”.

23.59 There are and will doubtless continue to be similar “empires” subject to the effective control of one person, but where it is difficult to have a clear understanding of the overall financial position at a point in time. Such understanding is essential in circumstances such as where there is inter-company trading or financial dependence by companies within “the empire” on each other or on common sources of funding.

23.60 In our opinion, auditors should be alert to the pitfalls in acting for such “empires” and given guidance in the conduct of such audits. Regulators should also be aware of these issues.

**(6) Auditors, independence and the detection of fraud**

23.61 As set out earlier in this report, the auditors to RM’s companies enjoyed a long standing professional relationship with RM and his companies and provided non audit services to his companies<sup>c</sup>. In the light of the conclusion<sup>d</sup> to which we came in relation to the audit of the pension schemes, we consider that there is the need for more radical thought and wider debate in the UK on the issues of auditor independence and detailed consideration of the rules being promulgated by the SEC and of the consultation paper issued by the EU Commission.

**(a) Non audit services: independence and conflicts of interest**

23.62 The importance of the independence and integrity of the audit of a company is self evident. There has been an increasing tendency for auditors to perform more non audit services to the company they

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<sup>a</sup> See paragraphs 4.57 and 4.60 to 4.63.

<sup>b</sup> Paragraph 22.61.

<sup>c</sup> See paragraphs 4.11 to 4.17. Their business valuation unit also provided a valuation of the newspaper titles owned by MGN (see paragraph 14.22 and Appendix 14). As set out at paragraphs 3.32 and 3.45 of Appendix 14, the issue of independence of CLD was carefully considered.

<sup>d</sup> See paragraph 22.9.

audit; for many firms this non audit work has become a significant part of their work. The conflicts of interest to which this give rise are obvious; the only issue is how this is best dealt with to maintain public confidence in the audit and to ensure that auditors are not only independent, but are perceived by the public to be independent, rigorous and robust in their audit of a company or indeed any entity. In the light of the events surrounding RM's companies and the pension funds, public perception and confidence should be seen as of central importance.

- 23.63 At present, the professional accountancy bodies are required to have rules to ensure that the auditor is independent of the audit client<sup>a</sup>; rules and guidance on ethics are set by the professional bodies under the overall supervision of the DTI<sup>b</sup>. Auditors are obliged to disclose their global audit fees and that proportion of non audit revenue that arises in the UK.
- 23.64 In 1999, following an agreement with H M Government for the establishment of an independent framework of regulation for the accounting profession, the accountancy bodies agreed to establish an independent foundation, known as the "Accountancy Foundation" to provide such a framework on a non statutory basis, subject to a review after 5 years. The "Accountancy Foundation" is to be funded by the accountancy profession. It is in the process of establishing a number of boards, including an Ethics Standards Board, 60 per cent. of whose members are to be non accountants. It is likely that the issue of auditor independence will be a matter for that Board but, as the Board had not been established in February 2001, we were unable to obtain its view on this issue.
- 23.65 The questions that arise are whether (1) the present position should be left unchanged and rules on ethical guidance should form the basis of ensuring auditor independence or (2) there should be a prohibition on an auditor of a company providing non audit services, particularly consulting services, to that company, or (3) there should be additional or more clear cut restrictions on certain services<sup>c</sup> where there is a clear inconsistency with audit independence rather than an outright prohibition of all non audit services or (4) there should be more disclosure particularly in relation to the detail of non-audit fees and services or (5) there should be statements of the independence arrangements in place, or (6) a combination of some of these.
- 23.66 These questions have been extensively debated in the USA where the SEC has taken an active role<sup>d</sup>. The SEC has addressed the main issues in new rules<sup>e</sup>, one of the principal features of which is to

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<sup>a</sup> Para. 7(1)(b) of Schedule 11 of the Companies Act 1989 and Article 24 of Directive 84/253/EEC.

<sup>b</sup> This work is done in respect of the three Chartered Institutes (ICAEW, the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland) by the Chartered Accountants Joint Ethics Committee which keeps the guidance under review. The Association of Chartered Certified Accountants has comparable rules and guidance.

<sup>c</sup> An example might be the valuation of an intangible asset by one part of a firm which is then audited by another part of the firm.

<sup>d</sup> See for example the speech by the Chairman at New York University Center for Law and Business on 10 May 2000. He expressed concern that "the audit function is simply being used as a springboard to more lucrative consulting services instead of augmenting the firm's core focus".

<sup>e</sup> Revision of the Commission's Auditor Independence Requirements: File No S7-13-00.

identify certain non-audit services (including some bookkeeping, valuation and legal services) which a firm cannot provide if it is to be an independent auditor.

23.67 The EU Commission following negotiations with Member States has issued a consultative paper “Statutory Auditors’ Independence in the EU: A Set of Fundamental Principles”<sup>a</sup> which considers auditor independence on statutory audits, including principles applicable to the provision of non-audit services.

23.68 In the UK, the debate has included:

- The Company Law Review Steering Group (whose functions we explain at paragraph 23.76) in a consultation document published in March 2000 identified the problem in these terms:

Another important development is the radical change in the structure of the accountancy profession, which raises the question about the auditor’s independence. In the early years of audit regulation the big accountancy firms derived a high proportion of their revenue from auditing. Today, these same firms are, in effect, financial services and consultancy conglomerates. There is a concern that potential conflicts of interest arise from combining these activities with the statutory audit function.

However although it was recognised that the “independence issue” needs to be kept in mind, the Group concluded that, although the matter should be kept under review and invited comments, it would “not be helpful to make specific proposals on auditor independence at this stage.”

In their further consultation document published in November 2000 they commented:

“We received a wide range of comments on this issue, many of which expressed concern about the increasing diversification of the major accounting firms and the possible threat to the independence of the statutory audit....

We note in particular the new Ethics Standards Board. These arrangements should ensure that issues of auditor independence are addressed. We do not believe that further change is desirable at this stage but would wish the legislation to be sufficiently flexible to enable change to the statutory arrangements were that to prove necessary.”

- In May 2000, the ICAEW established the Auditor Independence Working Party under the chairmanship of Mr Ian Hay Davison to review the issue of auditor independence<sup>b</sup>. In its report in August 2000, it concluded that an ethical framework approach along the lines of that currently operated in the UK was the most sensible approach to the requirement of independence.
- Simultaneously the Joint Monitoring Unit of the Institutes of Chartered Accountants published a review of compliance with the ICAEW’s guidance on independence. It concluded that there was no evidence of systemic or significant failure to comply with the guidance. It made some suggestions to the ICAEW Auditor Independence Working Party which did not “cast doubt on the general soundness and relevance of the current guidance”.

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<sup>a</sup> 15 December 2000.

<sup>b</sup> The Secretary of the Working Party, Mr Tony Bromell, was quoted in *Accountancy* as saying at the time of the announcement of the working party that the difference between the bodies approach to auditor independence were not huge. “Ultimately, some form of global standard will be adopted. We are all feeling our way towards it. The only organisation which was out on a limb was the SEC” he added.

- The Chartered Accountants Joint Ethics Committee are in the process of re-drafting the whole of its guidance on auditor independence issues in the light of the EU Commission paper.
- The importance of the role of a listed company's audit committee in giving detailed consideration to the issue of independence has been stressed<sup>a</sup>.

23.69 In addition,

- In July 2000, the Report of a Review Group on Auditing established by the Government of Ireland was published; auditor independence was one of the subjects it examined. It concluded that there was a need to introduce additional safeguards to protect the independence of the auditor from the threat posed by the provision of non audit services to client companies. It considered that these be best achieved through the development of a framework for auditor independence; they recommended full disclosure of non audit fees, restrictions on the amount of non audit fees and restrictions on certain non audit services.
- In July 1996 the International Federation of Accountants (IFAC) established a "Code of Ethics for Professional Accountants", which was updated in January 1998<sup>b</sup>. This set out common objectives for the accountancy profession worldwide and fundamental principles<sup>c</sup> that should be observed with the intention of serving as a model on which to base national ethical guidance.

23.70 The issues relating to auditor independence are important having regard to the events surrounding RM's companies and pension funds. Further consideration will be required in the UK to take account of the SEC rules and the EU consultative paper and to ensure, as far as possible, that there is a common approach with other EU States and the USA. This should contribute to a maintenance of public confidence in the independence of the audit and its value in identifying or preventing irregularities and abuses in companies and other entities and in their financial statements.

**(b) Rotation of auditors**

23.71 In June 1991, a senior partner of the auditors to RM's companies set out his view of the firm's strategy<sup>d</sup>:

"The first requirement is to continue to be at the beck and call of RM, his sons and staff, appear when wanted and provide whatever is required."

The partner had been responsible for audits for many years.

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<sup>a</sup> The Audit Briefing Paper "Communications between external auditors and audit committees" issued in June 1998, stated that an audit committee's role can be expected to include considering the adequacy of arrangements for external audit and supporting the independence and objectivity of the external auditors by, inter alia, reviewing the nature and extent of non-audit services.

<sup>b</sup> An exposure draft of proposed changes to the Code of Ethics for professional accountants was issued in June 2000. The proposed changes set out a framework describing the factors that could threaten a reporting accountant's independence and the safeguards that can be put in place to preserve that independence.

<sup>c</sup> The fundamental principles identified were integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

<sup>d</sup> See the footnote to paragraph 4.12.

23.72 In our view the same person should not be responsible for an audit of a listed company for more than a given number of years so that a fresh and objective view is regularly undertaken. There are two principal means by which this could be achieved:

- Compulsory rotation of partners<sup>a</sup>.
- Compulsory rotation of firms.

The EU Consultative Paper to which we have referred provides for rotation of audit partners for public interest companies. There are benefits and disadvantages in both of these alternatives<sup>b</sup>.

**(c) The expectations gap and fraud**

23.73 In a consultation document published in March 2000, the Company Law Review Steering Group (whose function we explain at paragraph 23.76) observed:

“In reality auditors cannot be expected to detect a carefully planned and well executed fraud. This has led to a so-called “expectations gap” – that is the gap between what auditors can achieve and what users think they can achieve. Part of the work of the Auditing Practices Board is to explain and debate these issues to bring public expectation and what is possible into line, though this is a far from easy task.”

In November 1998, the Auditing Practices Board issued a consultation paper “Fraud and Audit: Choices for Society” which was intended to inform and stimulate debate on the actions that should be taken to establish the right balance between the benefits to society from increasing the auditor’s role in relation to the detection of fraud, and the costs and consequences that would flow from such changes.

23.74 Although we accept that a well planned and executed fraud can be difficult to prevent or detect and the primary responsibility to prevent and identify a fraud is that of the directors of a company, there is more that auditors can and should be doing to help prevent fraud:

- **Whistle blowing:** There should be a general duty<sup>c</sup> on auditors to inform the DTI and, where appropriate, the FSA of significant fraud or illegality at a listed company which it discovers in the course of an audit; we understand that the duty of whistle-blowing has worked well in

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<sup>a</sup> The current Guide to Professional Ethics of the ICAEW (effective from 1 September 1997) requires audit firms to ensure no audit engagement partner remains in charge of the audit of a listed company for a period exceeding 7 years (without returning to the audit engagement partner role for at least 5 years). If this solution were adopted, it would be essential to prevent a more junior partner or senior manager who had worked with the partner assuming the responsibility, though provisions would need to ensure proper arrangements for the transfer of information and lessons learnt from experience.

<sup>b</sup> The Irish Review Group on auditing considered this topic.

<sup>c</sup> The current section of the Guide to Professional Ethics (1.306) of the ICAEW places a heavy emphasis on the duty of confidentiality which in the context of the relationship between a company and its auditor is a very important consideration. The Statement of Auditing Standards (Number 110) issued in January 1995 by the Auditing Practices Board requires auditors becoming aware of suspected or actual fraud to consider whether the matter ought to be reported to a proper authority in the public interest.

relation to pensions and to firms regulated under the Financial Services Act<sup>a</sup>. Its more general extension would be highly desirable.

- **Maintenance of the independence of auditors.** We have addressed this topic above.

**(7) Corporate governance of listed companies: chairmen, directors and non-executive directors**

23.75 Since the flotation of MGN, three committees have reported on corporate governance - the committee under Sir Adrian Cadbury in 1992, the committee under Sir Richard Greenbury in 1995 and the Committee under Sir Ronald Hampel in 1997. As a result of the reports of these committees, the Combined Code was produced by the Stock Exchange in June 1998. The Listing Rules were amended with effect from 31 December 1998 to require a company to state how it has applied the principles set out in the Combined Code; where it has complied with only some or none of the Combined Code provisions, it must specify the Combined Code provisions with which it has not complied and give reasons for non compliance.

23.76 In March 1998 HM Government announced a fundamental review of company law to be overseen by The Company Law Review Steering Group, a group of independent experts, which is due to report in the summer of 2001.

**(a) The preferred approach**

23.77 Some commentators have observed that it would have been possible for MCC and MGN under the chairmanship of RM to have complied with the provisions of the Combined Code if the provisions were applied simply as a checklist with boxes to be ticked and standard statements to be made without analysis of whether there was compliance with the spirit of the Combined Codes. We see considerable force in such comments. However, we consider that the preferred approach to corporate governance is still to deal with it by code rather than detailed legislation<sup>b</sup>, though there is a need to underpin codes by making legislative provision<sup>c</sup> for them and to provide effective sanctions that can be enforced.

**(b) Directors' understanding of their duties**

23.78 Prior to the flotation of MGN, Clifford Chance<sup>d</sup> provided the directors with a memorandum on the liabilities of directors for listing particulars and the other duties of a director of a listed company; it did not (and was not intended) to deal with corporate governance. In March 1991, Inspectors reporting on Bestwood plc recommended<sup>e</sup> that a code of directors' duties be formulated; in the preliminary recommendations we made in July 1995 we strongly endorsed the principle of this

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<sup>a</sup> The Public Interest Disclosure Act 1998 which came into force in July 1999 encourages whistle-blowing by employees by affording them a measure of protection from dismissal and victimisation.

<sup>b</sup> There are strong arguments to the contrary; we are grateful to Lord Williams of Elvel for his submissions to us on this topic.

<sup>c</sup> One method which could be used to underpin codes and similar extra statutory documents would be to give the Courts express power to have regard to them when assessing the conduct of directors.

<sup>d</sup> See a footnote to paragraph 10.23.

<sup>e</sup> Paragraph 18.6.2.

recommendation made by those Inspectors and advised that fiduciary duties should be covered in the formulation.

23.79 In September 1999, the Law Commission in their Report *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties*<sup>a</sup>, recommended partial codification of directors duties which was summarised as follows:

“We recommend that there should be a statutory statement of a director’s main fiduciary responsibilities and a director’s duty of care and skill; this statement should be set out on forms 10(2) and 288a; that when a director signs such a form he should acknowledge that he has read this statement; and that the DTI should consider how pamphlets explaining a director’s duty might be made available to directors.”

This recommendation is now being considered by the Company Law Review Steering Group, which, we understand, has expressed strong support.

23.80 We consider that, in addition to the statutory statement, the provision of practical extra statutory Guidance on Directors’ Duties is clearly needed. This Guidance would deal with matters such as corporate governance and should be regularly updated. Not only would this provide useful assistance to directors, but leave less room for argument on the scope of duties in the case of corporate failures. We recommend that the work to prepare such Guidance be put in hand by the DTI as soon as possible.

23.81 We also recommended in July 1995 that the listing rules be amended so that the sponsor was bound to ensure that the directors understood not only their duties under the listing rules<sup>b</sup> but also in relation to all their obligations as directors, including those as to corporate governance and financial controls. We understand that this has been accommodated in the requirements of the Combined Code.

23.82 We recommend that when the extra statutory Guidance on Directors’ Duties (which we have recommended) has been prepared under the auspices of the DTI, the Combined Code should be revised to include a reference to directors of all listed companies having undertaken to abide by the terms of the Guidance.

**(c) Executive Chairman**

23.83 One of the undesirable features of MGN on flotation was that it had an executive chairman and no separate chief executive. We expressed the view in July 1995 that we agreed with the conclusions of the Cadbury Report<sup>c</sup> that the office of chairman and chief executive should not generally be combined.

23.84 The Combined Code provides:

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<sup>a</sup> Law Com. No. 261.

<sup>b</sup> This obligation is in Purple Book at Rule 2.9.

<sup>c</sup> Paragraph 4.9 of that Report.

“There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. A decision to combine the posts of chairman and chief executive in one person should be publicly justified. Whether the posts are held by different people or by the same person, there should be a strong and independent non-executive element to the board with a recognised senior member other than the chairman to whom concerns can be conveyed. The chairman, chief executive and senior independent director should be identified in the annual report.”

23.85 The combining of the functions of chairman and chief executive at MGN should not have been permitted<sup>a</sup> and we doubt whether the provision in the Combined Code would have been sufficient to prevent it. We therefore recommend that the working of this provision be monitored. A possible revision to ensure the elimination of combining these offices in listed companies in all but the most exceptional and objectively justifiable circumstances should be kept under review.

23.86 If a company which combines the posts of chairman and chief executive is applying to be listed, the Listing Authority should require a comfort letter from the sponsor to the effect that, having considered the implications, it was satisfied that no detriment would be likely to arise. The view has been expressed to us that advisors and shareholders are fully aware of the risks of combining the posts of chairman and chief executive; as a result of our investigation, we are not as sanguine and consider a comfort letter from the sponsor is necessary.

**(d) The role of non-executive directors**

23.87 It is clear from chapters 20 and 21 that the presence of non-executive directors contributed little to MGN. It would have been helpful

- If those appointed on flotation had familiarised themselves sufficiently with MGN.
- If there had been a clearer understanding of the time they had to devote to the affairs of MGN.

23.88 In our view the way a company governs itself should (within the requirements of the EU directives and the Companies Act) generally be a matter for the shareholders and directors to decide; we do not consider that detailed legislation is therefore needed to regulate further corporate governance, though it will be necessary, as we have stated, to underpin the codes of practice. We agree with the approach of the Combined Code that a company should have non-executive directors of sufficient calibre and number for their views to carry significant weight in the board’s decisions. Furthermore, it should be for each company to decide on the particular role of a non-executive director. Legislation is not required to ensure that a non-executive director familiarises himself with the company.

23.89 The key issue is how to make non-executive directors properly accountable for the responsibilities they undertake within the company (as responsibilities may differ from company to company) and thereby act more diligently in carrying out such responsibilities. Further consideration could usefully be given to this issue<sup>b</sup>.

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<sup>a</sup> See paragraph 22.19.

<sup>b</sup> It was submitted to us that cronyism plays far too large a part in the preservation of the present position. Companies like to chose non-executives from a narrow circle of those that they are likely to get on with; there is no wish to see the present position changed by anything that might risk disturbing the existing cosy relationships and opportunities.

23.90 We consider one way to ensure that:

- the role of the non-executive director within the particular company is defined<sup>a</sup>;
- the time he has to devote is made clear
- the non-executive is accountable for what he does and the time he spends

is to make it a provision of the Combined Code that the annual report should also contain:

- a statement setting out the functions carried out by the non-executive directors within the company;
- a statement of the time that each non-executive director has actually spent on the affairs of the company during the year<sup>b</sup>.

23.91 The view has been expressed to us that it is doubtful whether there would be support in the City or from institutional shareholders for our suggestion. For our part we consider that there is a strong interest in ensuring greater accountability and transparency and thereby enhancing public confidence.

**(8) Technical matters**

**(a) Definition of realisation**

23.92 As is clear from the scheme devised to enable the elimination of the debt of the private side to MGN (described at paragraphs 15.6 to 15.14 and in Appendix 15), section 263 of the Companies Act 1985 is unsatisfactory in that it fails to deal with realisation within a group context and may be ineffective in restricting the funds that are distributed within a group. We recommended in July 1995 that this issue be addressed.

23.93 As we explain at paragraph 8 of Appendix 15, in 1994, the Accounting Standards Board issued Financial Reporting Statement Number 5 under which financial statements were required to report the substance of transactions.

23.94 In July 1999, the ICAEW began developing new guidance on the determination of realised profits. A draft technical release issued in August 2000<sup>c</sup>, provided a much clearer definition of considerations to be taken into account in assessing whether there was a “realisation” and in paragraph 12 stated:

“In assessing whether a company has a realised profit, transactions and arrangements should not necessarily be looked at in isolation. A group or series of artificial, linked or circular transactions or arrangements that is designed to achieve an overall commercial effect (for example, the creation of a realised profit) should be viewed as a whole, and a realised profit does not arise where the end result for the company does not meet the criteria set out in this statement.”

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<sup>a</sup> The SEC issued in September 1999 useful guidance on independent directors of investment companies, particularly in relation to conflicts of interest.

<sup>b</sup> A survey published in 2000 by PricewaterhouseCoopers “Non Executive Directors: A survey of practice and opinion” provided some information on time spent; the author of the survey observed (at paragraph 55) in respect of their finding that non-executive directors were spending somewhere between 10 and 20 days on the job, “These do not seem very high figures in relation to the demands of the role as they have been described”.

<sup>c</sup> Tech 25/00.

23.95 The view has been expressed to us by the DTI that this is not a suitable area for statute law because of the complexity of intra group transactions and that it should be dealt with by the new guidance being developed and the interpretation of the current law. We have considerable sympathy with that view. We understand the guidance will be finalised and available in the course of 2001. The guidance will need to deal expressly with the type of transaction that occurred at MGN.

**(b) Options**

23.96 The Bestwood Inspectors recommended in March 1991 that the prohibition of the purchase of options by directors should be extended to the sale of options<sup>a</sup>; we endorsed that recommendation in July 1995.

23.97 In 1998 the Law Commission issued a consultation paper<sup>b</sup> by which comments were sought as to their provisional view that section 323 of the Companies Act 1985 should be repealed. In their Report of 1999<sup>c</sup>, the Law Commission recommended the repeal of section 323 on the basis that the mischief that it was designed to cover – insider dealing – has been dealt with by Part V of the Criminal Justice Act 1993. The Law Commission is plainly correct, but (as RM's dealings in MCC shares reveal) insider dealing is not the only possible mischief. Another mischief could be share support, in particular through the use of options during closed periods<sup>d</sup>. Whilst that might be contrary to the Combined Code, RM's dealings reveal that a statutory prohibition backed up by criminal sanction may well still have a real purpose. We recommend that the Company Law Review Steering Group consider this issue further.

**(c) Disclosure of a director's loans secured by shares**

23.98 The Bestwood Inspectors also recommended in March 1991 that the law be amended to require directors of listed companies to reveal details of any loans (say over £20,000) which are secured by shares in the company<sup>e</sup>. Their reasoning was that other shareholders were unaware of the risk of a director being forced to sell blocks of shares at short notice if he could not service his borrowings or if the value of the shares fell. We endorsed that recommendation in 1995 and suggested that the provision should be drafted widely enough to cover all holdings whether held directly or indirectly. The events we describe in this Report show that there is a further risk arising out of a director borrowing against the collateral of large shareholdings – manipulating the market to keep the price high to maintain adequate collateral for loans. We also recommended that consideration should also be given to extending this disclosure requirement to the use of shares as collateral by shareholders holding more than 3 per cent. of the shares of the company.

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<sup>a</sup> Paragraph 24.5.11; section 323 of the Companies Act 1985.

<sup>b</sup> No 153 Company Directors: Regulatory Conflicts of Interests and Formulating a Statement of Duties.

<sup>c</sup> Law Com No 261.

<sup>d</sup> The Working Party appointed by the Stock Exchange to consider RM's dealings in options also recommended that amendment to section 323 be considered (see Appendix 7, paragraph 19.4).

<sup>e</sup> Paragraph 24.5.10.

23.99 This issue is not presently being considered by the Company Law Review Steering Group. We recommend that this issue be addressed.

**(d) Disclosure for the purposes of a criminal trial**

23.100 We were invited to make observations in 1995 in relation to the disclosure in criminal proceedings of materials obtained during the course of an Inspection prior to the enactment of the Criminal Procedure and Investigations Act 1996 which has modified the law. A large amount of material we had obtained was disclosed shortly before the criminal trial started; this caused considerable concern to those who had made available information to us, some of which would not have been available otherwise, for example, because it was the subject of legal professional privilege. When the law relating to disclosure is next reviewed, we recommend the review consider the circumstances relating to our enquiry for the reasons we have given. We would hope that any future modifications of the law will not discourage the voluntary disclosure of information to enquiries (particularly of confidential or privileged information). We also suggest that consideration should be given as to whether it is appropriate to provide safeguards in respect of information disclosed to enquiries under compulsion, though this may require a balancing exercise to be undertaken by the court.

**(9) Review of recommendations**

23.101 Recommendations in reports such as this are sometimes implemented, sometimes rejected, sometimes considered for long periods and sometimes ignored. For example, nearly 10 years after the Bestwood Report, the recommendations to which we referred are still being considered. There is a public interest in knowing what the response has been to recommendations made. Providing such a statement would be in accord with a modern approach to government. We would therefore recommend that the DTI publish from time to time reports dealing with, or include in their annual report, their responses to the recommendations made by enquiries such as this and, where decisions are made to implement recommendations, the progress towards implementation.