

RESPONSE OF ELEN MACPHERSON

12 July 2002

Dear Derek,

I have been interested to see that you are carrying out a review for the Government of the Non Executive Director's role. As you will be aware, since leaving 3i where I worked for 27 years, I have been involved in a number of Non Executive posts that are shown in the attached schedule.

I have decided to write to you because, perhaps unusually, my career has straddled the private equity/venture capital sector and the public company sector. I wanted to let you have my observations because I perceive that the role of corporate governance is handled very differently in the two sectors and, I have to say, I think it is more effective and more decisive in the private equity/venture capital sector. Let me try to explain what I see as the differences and why I have come to this conclusion.

1. Private Equity/Venture Capital

Companies in the private equity/venture capital sector tend to be characterised by a concentration of ownership where the interests of the principal shareholders are closely aligned with the management. Indeed, in most cases, the management will have a significant shareholding as well as the institutional shareholders who are normally small in number and who have a (relatively) good knowledge of the business.

Frequently, there will be a 'lead' institutional shareholder representative on the board of the company. Board meetings therefore provide a regular and useful forum for communication with the shareholder interest, apart from regular reporting issues. In particular, decisions can be reached relatively quickly, privately and unobtrusively between management and shareholders about major financing issues, which may involve shareholders saying 'no'. But, above all, I believe it is the alignment of interests which helps the direction of the company and the dynamism of the sector.

2. Public Companies

By contrast, in the public company arena, ownership is frequently highly fragmented and, in some cases, management has very little or no interest at all in the shares of the company. My perception is that the emphasis of management then tends to switch to lifestyle or empire building.

In the former case, salary, pension and perks are important. In the latter, the management may have more dynamism in terms of corporate activity, but are concerned with “winning the deal” so that their empire is enlarged almost regardless of the effect on shareholder value.

Remuneration consultants will then advise the non-executive remuneration committee that the corporate executives should have a higher salary because of the relative size of the business – nationally, internationally, FTSE-100 related or whatever. So salaries go up, and so do the ultimate pensions, at great cost to the company, and in my view, frequently at no improved value for shareholders. No thought is given to organic growth of the company, because that is perceived to be altogether too slow and tedious.

What has surprised me in the public company boardrooms in which I have sat is first the extreme reluctance of non-executives to say “no” to management. Secondly, it also surprises me, though it has not happened in any of the companies with which I have been involved, that shareholders also virtually never say “no” when a financing proposal is put to them. Thirdly, it has surprised me that the major institutional shareholders are so remote from the managements and/or boards.

At boardroom level, I would observe that chairmen are keen to adopt a team approach and abhor a situation which does not leave them with a unanimously favourable vote on an issue. There is therefore huge pressure on the non executive directors to “conform”, and most of them do so because they have worked in the public company sector themselves, tend to be corporate deals orientated, empire builders, rather than shareholder value orientated entrepreneurs or interested in organic growth of the business. The attitude seems to be “The Board must back the Executives until you sack them”. I think it will be almost impossible to change this attitude unless institutional shareholders start appointing their own direct representatives.

At a public company institutional shareholder level, in many cases there is a reluctance to have meetings with companies because of “insider dealing” issues; and in many cases the fund managers have such narrow backgrounds that they are not capable of seriously questioning the management or the board: the attitude then arises (for which the institutions are criticised) “if you do not like it, sell it”.

3. Other Issues

Although I decided to write this letter to you when I saw the announcement of your appointment, I started the actual process of writing at the end of the week which had been full of corporate governance news, in particular the announcement about the litigation against the ‘old’ board members of the Equitable, continuing difficulties at Marconi, the resignation of Roger Hurn from the Prudential; and, of course, the continuing news about the Enron collapse and its effect on Arthur Andersen. There was also the report on the speech by Lord Young at the IOD suggesting that non-executive directors were, in effect, a waste of time and, more recently, there has been World Comm.

No system of corporate governance is perfect and whatever system is in place will not prevent collapses. Currently, however, I believe increased regulation (draconian FSA powers), litigation (Equitable), and bad press (see above) is reducing the pool of available non executive directors which may perversely tend to reduce the effectiveness of corporate governance in our major companies. The action of the new Equitable Board against the old board members is a huge disincentive to becoming a non-executive director. Many of the old board members are likely to be bankrupted by the legal fees, let alone anything which may come out of the legal process itself. And, I assure you, the former directors are not covered by D&O insurance.

If non-executive directors adopt an extremely cautious attitude in order to try to avoid problems, is this of benefit to the shareholders?

4. The Way Forward

So how can one deal with the fragmentation and remoteness of shareholders in public companies and at the same time increase the effectiveness of non-executives in their corporate governance role?

I put forward the following personal thoughts:

1. There should be more direct contact between Boards (executives and non-executives) and shareholders. The corollary of this is that major institutional shareholders must staff themselves accordingly, and be able to field people of adequate calibre to deal with major companies.
2. Institutional shareholders should be prepared to say “No”, and to stand up and be counted if necessary. What is the voting system for if not occasionally to stop things happening? This also applies to non-executives on boards of major companies.
3. Some thought should be given to the ABI and NAPF playing a greater role in this area, particularly as representatives of many smaller institutions. Indeed, in some cases, it might be appropriate for an ABI/NAPF representative to work with a major institutional representative to sort out a perceived problem.
4. Just as, in the various crises we have had over the past several decades, a system evolved in the banking community of the “lead bankers” in helping sort out company problems, so I believe should a system evolve of having a “lead institution” to ensure an orderly process at certain stages in a company’s history. For example, it might be appropriate for a lead institution to emerge to respond to proposals for a controversial take-over, or when a company’s share price has been relatively very weak.
5. Some degree of change might be required in the FSA rules and regulations to ensure “concert party” and “market abuse” issues did not arise if some of these suggestions were developed further.

I have some sympathy with Lord Young’s comments, referred to above: however, I have seen how relatively effective non executives can be in the private equity/venture capital sector and I believe that, in the public company sector, there should be more direct shareholder input, through various mechanisms as outlined above, to help improve corporate governance and the development of companies to improve shareholder value.



Ewen Macpherson