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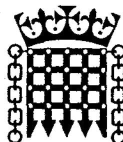

HOUSE OF COMMONS
LONDON SW1A 0AA

5th August 1992

Dear Mr. Peace,

I have great pleasure in sending you the Liberal Democrat response to the Cadbury Committee's draft report on the financial aspects of corporate governance. Please accept my apologies for overshooting your original deadline for comments, but I understand our comments can still be considered. I hope our comments will be of use.

Yours sincerely,

p.p. David Davey
Economic Adviser

Malcolm Bruce MP
Liberal Democrat Trade and Industry Spokesman

Mr.Nigel Peace
Secretary to the Committee on Financial Aspects of Corporate Governance
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THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

COMMENTS

on the

Draft Report

of the

CADBURY COMMITTEE

by

THE LIBERAL DEMOCRATS

1 INTRODUCTION

1.1 The topic of corporate governance has risen up the political agenda in the wake of various well-publicised company and City scandals, of which the Maxwell case was the most dramatic. In our view, it also has an intrinsic importance which has historically been overlooked.

1.2 In this context, we welcome the publication of the draft report of the Cadbury Committee, and the clarity with which it has addressed the various issues involved. Our basic criticism is encapsulated in the newspaper comment that the draft report was "a timid step in the right direction". In particular, we fundamentally disagree with the draft report's rejection of a statutory approach, and its acceptance of the present system of auditing.

2 OUR POLICY

2.1 In our recent General Election manifesto, we said that we would "define the responsibilities of non-executive directors, and insist that all publicly quoted companies have them on their boards".

2.2 In "Citizens at Work", an interim statement of policy approved by our Federal Conference in September 1990, we proposed inter alia structures for employee participation in corporate governance, in terms of both strategic and day-to-day issues. These proposals are set out in the Appendix to this document.

3 THE CODE OF BEST PRACTICE

3.1 We welcome the contents of the Code of Good Practice. In particular, we believe that the imposition of a Stock Exchange obligation on listed or quoted companies to include a compliance/derogation statement in their annual reports will ensure that shareholders receive information on the important topic of corporate governance.

3.2 We would go further than the Report, and insist that it is unacceptable for the same person to be both chairman and chief executive. We firmly believe that, in large companies, shareholders and employees are better served by keeping these posts separate.

3.3 We also strongly disagree with the view that a non-binding Code alone will result in the sort of changes that are needed. The role of the London Stock Exchange will not be to ensure compliance with the Code in the case of listed and quoted companies, but rather to ensure that derogations are disclosed. Even on this basis, the only sanction exercisable by the Stock Exchange is the "nuclear weapon" of suspending or cancelling the listing or quotation of the shares of the company concerned, which penalizes above all the very shareholders whose interests are supposed to be protected.

3.4 Accordingly, while we see merit in the Code as a short-term measure, not least because of the lead time for legislation, we regard it as essential in the longer term that the contents of the Code receive the backing of statute law. We accordingly fundamentally dissent

from the remarks at paragraph 1.8 of the draft report. Firstly, we believe it to be a myth that a statutory framework is incompatible with a flexible approach; nor, in our view, does the myth become true by constant repetition. Secondly, there is no evidence for the proposition that, because statutory measures would impose a minimum standard, there would be a greater risk of companies complying with the letter of the law rather than its spirit; as a matter of logic, this is an (unintended) insult to those companies which have already installed good systems of corporate governance.

3.5 In particular, we think it necessary that the existence and functioning of audit committees should be required by statute.

3.6 While a statutory version of the Code, with the changes we have suggested, would be a significant improvement, it would, like the Report, completely exclude one area of reform where we believe changes would make a significant difference to corporate governance, namely employee involvement. Liberal Democrats strongly believe that the voice of employees in the process of management decision-making, including the reporting of finances, would have a beneficial impact on corporate governance, and is therefore in the shareholders' interest.

3.7 We support increased employee involvement in management because we believe that this can only improve the performance of companies, and because we think it is right for individual employees to have a greater input into decisions that affect their lives. As will be seen from the Appendix, our general approach is to avoid

prescription, and to enable different companies to adopt different approaches; we do, however, believe that experience abroad suggests that some models work better than others. We particularly favour employee committees at lower tiers, and employee representation within a supervisory board structure.

4 FINANCIAL REPORTING

4.1 Financial reporting is subject to Gresham's Law in reverse: bad practices drive out good, as companies compete to present their position in the most favourable light, and the accounting profession competes for audit work.

4.2 While we join the draft report in endorsing the objectives and welcoming the efforts of the Financial Reporting Council and the Accounting Standards Board, we nevertheless consider that a system under which accountants act as financial advisers, and then in effect audit their own handiwork, breaks a fundamental principle that nobody should sit in judgment on himself. We therefore take the view that the audit function should indeed be "quarantined" from other accountancy functions.

5 CONCLUSION AND RECOMMENDATION

We welcome the draft report, and recommend that the final report be modified to reflect the foregoing comments.

July 1992

APPENDIX

Structures for Participation

1 Introduction

1.1 It is part of our fundamental belief in the rights of the individual that each employee should have rights as such to participate in the running of the organisation for which he or she works, whether or not he or she is also a shareholder.

1.2 For many years the democratisation of the structure of industry was a major theme in Liberal Party policy. As far back as 1928, the Liberal "Yellow Book" (Britain's Industrial Future) included a detailed blueprint for works councils. Between 1948 and 1968 this was complemented by policies for supervisory boards representative equally of employees and shareholders. These ideas have largely been ignored by industry and by successive governments but, from 1978 onwards, there has been some legislation to encourage employee share ownership, a major strand of our approach.

1.3 Our guiding principles are that those employed to manage enterprises should be able to do so effectively on a day-to-day basis - provided that they have secured the consent of employees and shareholders to their objectives - and that the methods for securing this consent should be adapted flexibly to the nature of each organisation. We do not aim to impose rigid structures of participation on organisations. Instead, we would legislate to establish an employee's right to participation. The firm or other body would then be free to draw up its own proposed structure, and submit it for approval to an Industrial Partnership Agency ("IPA"), which would be established by statute, either as a separate body or as an extension of ACAS, to advise on appropriate structures, and in the ultimate have powers of arbitration and imposition.

1.4 The proposed scheme would have to satisfy minimum criteria, laid down in the legislation, and harmonised with forthcoming European Community legislation in a number of key areas, including participation in and consultation on both strategic decisions and day-to-day matters. The following sections describe possible structures, but it should be stressed that these are just examples; we wish to encourage innovation and diversity in the field of participation as much as anywhere else.

2 Participation in Strategic Decisions

2.1 We believe that employees should have a voice in strategic decisions about the future existence or nature of most organisations in the private and public sectors - including mergers, take-overs, major acquisitions and disposals, and closures (with or without relocations). In practice, this will mean board-level representation of employees.

2.2 The European Community's proposed Fifth Directive on Company Law includes options for the introduction of either a two-tier system of separate supervisory and management boards, or a one-tier board with a formal division of the supervisory and management functions. These

are indicative of the types of schemes which might satisfy the IPA. In our view, a two-tier system is much to be preferred, especially in larger companies, in order to clarify the different responsibilities of the two bodies; we have therefore examined it in more detail below.

2.3 Supervisory boards would discuss the strategy of the organisation in such matters as investment, diversification and recruitment, and establish the guidelines within which the executive directors ran the business. However, all operational decisions would be taken by the chief executive or by a lower-tier board that he or she chaired, except for the strategic issues listed in paragraph 2.1, which would be reserved to the supervisory board. The supervisory board would also appoint and dismiss the chief executive. He or she would make all other executive appointments, and would submit annual reports and accounts to the supervisory board for approval and presentation to the shareholders and employees who would constitute their electorate.

2.4 Various methods can be employed for electing directors to supervisory boards. We would favour a single list of candidates with a single transferable vote for each employee and a fractional vote for each share so that the totals of potential shareholder and employee votes would be equal. Other options, however, including shareholders and employees electing equal numbers in a electoral college which would then elect the directors, or separate election of employee and shareholder directors in equal numbers (with an independent chair), are possible. It is important, though, that employees as a whole should be able to exercise 50% of the total votes, or they risk being consistently outvoted. If our favoured method of election were adopted, successful candidates would be those who secured votes from both employees and shareholders, and not those who relied on the support of one category exclusively.

2.5 Holding companies within the UK could have supervisory boards, with employees in all subsidiaries having voting rights. UK subsidiaries of holding companies overseas could have supervisory boards whose decisions could not be overruled by the holding company. This would not be necessary, however, for a European Company with its own supervisory board under EC statutes. In a nationalised industry the shareholder votes should be exercised by the Minister, after consulting Parliament; the employee votes would be exercised as in the private sector. The powers of the supervisory boards of nationalised industries and private monopolies would be subject to existing statutes.

2.6 We would not accept as alternatives to this kind of board-level representation the EC options for collective agreements between employers and trade unions and for best existing practice. It is very difficult to see how, if there is to be participation in strategic decisions, it could be operated through employee committees rather than supervisory boards. Either it would provide for consultation of employees before strategic decisions were made, but no control by the employees over such decisions, or employee committees would have to be given a veto, which is a greater power than employees would have by equal participation in supervisory board elections.

2.7 Not all organisations would be suitable for board-level representation, whether through supervisory boards or other structures. We would start with the larger organisations, of a size to be determined by the IPA (EC draft Directives currently envisage 1,000 employees or more); this could be extended later, but it is likely that only a minority of companies would become obliged to implement such structures. Most partnerships and cooperatives would be too small for these to be needed; for larger ones, special provisions would have to be devised by the IPA.

2.8 Finally, this form of participation could not function in elected government authorities, non-profit making services, such as education or health, run by those authorities, or non profit-making organisations with governing bodies elected by their members. To do so would be an infringement of the democratic rights of the public as a whole in Parliamentary or local council elections, or of the membership subscribing to the organisation. Most of the decisions for which a supervisory board or similar structure would be responsible, however, are taken only by trading organisations. The right of consultation would still apply, however, and it is to this subject that we now turn.

3 Employee Committees

3.1 As well as participation in strategic decisions, we also wish to see structures established to guarantee participation in more immediate, day-to-day, matters - those for which the lower-tier board in a two-tier structure would be responsible. In addition, even in circumstances in which board-level representation is inappropriate, we wish to establish a right of consultation over most matters. A system of elected Employee Committees can fulfil both these purposes, and we would therefore encourage their establishment in all organisations. In smaller bodies, such formal structures may not be necessary, but for larger ones (over a threshold to be decided by the IPA) Employee Committees would be mandatory.

3.2 In many UK companies works councils have been constituted, but their agendas have often been confined to fairly peripheral welfare issues. Following German practice, we use the term "employee committee" rather than "works council" for two reasons. Firstly, we want to stress that the concept is applicable not solely to factories, but to all kinds of working environments. Secondly, we recommend that only the elected representatives of the employees should be committee members as of right and that others - including management - should be invited, rather than the meetings being considered as a joint forum for management and employee representatives. This is only one of the many respects in which flexibility should be encouraged.

3.3 The powers of Employee Committees in other countries, for example the Netherlands and Germany, are many and varied. There is no set pattern. On some matters, Employee Committees have codetermination powers - meaning that management may not implement a change without the Committee's agreement. In the case of disagreement, however, it is usual to provide for an arbitration system to break the deadlock. On other matters, especially in the Netherlands, Employee Committees

have the power to delay management decisions for up to a month. Other areas still are dealt with by giving the Committee a right to be consulted or, at the lowest level of participation, the right to be informed.

3.4 We envisage a system that gives Employee Committee rights of all these kinds. The details would of course vary to suit the individual circumstances of each organisation, and would be subject to approval by the IPA. Our preference, however, would be for Committees to have codetermination powers over health and safety policy and profit-sharing arrangements, and delaying powers over redundancies and changes in working practices. We would propose at least consultative rights over most other matters (including training, principles of promotion and quality schemes), leaving information rights for a small residual category - including a right to receive the same information as shareholders, and, at least half-yearly, an adequate explanation of the company's trading situation.

3.5 Employee Committees would have no power to detract from the existing statutory provisions such as those concerning unfair dismissal and discrimination. Their functions would not affect arrangements for collective bargaining on pay or contracts of employment. A Committee could only take over negotiations with management on these issues if specifically invited to do so by any recognised unions.

3.6 Employee Committees would be elected by all employees over 16 who had worked in the organisation for a defined period (say one year). All elections would be held by the single transferable vote. Constituencies could be determined by location, function or grade. It would be unwieldy to have a single Employee Committee in a large organisation, and preferable that there should be a separate sub-committee for each distinct unit with 1,000 or so employees. A coordinating committee could then be elected, either directly by the workforce, or by the sub-committees. In organisations with a highly dispersed workforce, the necessary processes of consultation may have to make extensive use of written communication.

3.7 Only elected members of the Committees would have the right to vote, convene meetings and place items on the agenda, although others (functional managers, technologists, union officials, external advisers and so on) who represented particular views or expertise could be invited to attend and speak. Managers, like other employees, would be entitled to vote and stand for election. Employee Committee members would be entitled to receive information sufficient for their responsibilities; management could designate such information as confidential and any breach of confidence would disqualify the member from continuing in office and from future election. The statutory constraints on insider dealing would apply to Employee Committee members in listed or quoted companies.

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