CAD-01167

hi Adrian

Copy for your retention.

ifma

INSTITUTIONAL FUND MANAGERS' ASSOCIATION

Nigel Peace Esq.
Secretary
Committee on The Financial Aspects
of Corporate Governance
PO Box 433
Moorgate Place
London
EC2P 2BJ

30 July, 1991

Dear Mr. Peace

Thank you for your letter of 26 July asking about the papers produced by the Association on Voting by Shareholders and on Communication of Business Plans and Insider Dealing. I do, of course, know all about your Committee and was sorry to miss the presentation which Adrian Cadbury gave at the CBI Steering Group meeting on 25 June, at which we were represented by Peter Stormonth Darling.

I am sorry that you have had to remind me to send you copies of the two papers and I enclose them herewith. The paper on voting has been made public, but the paper on insider dealing is still at the discussion stage and has only been circulated to the members of the CBI Steering Group and the Institutional Shareholders' Committee and should therefore be treated as confidential until all their comments have been received and incorporated in the final version. We would be interested to have any comments which your Committee might care to make.

I think it probable that we will wait for your draft report in the new year before giving you our views on the issues in front of your Committee.

Yours sincerely

Charles Nunneley

C.K.R. Nunneley
Chairman

Encs.

P.S. My name is subject to endless variations of spelling but your secretary might like to note the correct one for the record!

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INSTITUTIONAL FUND MANAGERS' ASSOCIATION

VOTING BY INSTITUTIONAL SHAREHOLDERS

The growing interest in corporate governance in all its forms has begun to light up a previously unnoticed corner of institutional fund management – the way in which discretionary managers use the votes attached to their clients' investments. Several recent publications are evidence of this, among them the ABI's discussion paper on "The Responsibilities of Institutional Shareholders", which has a section on voting, and a paper produced for a meeting of the Institutional Shareholders' Committee, which shows the results of a survey of voting habits among institutions.

Existing voting practices

The ISC survey covered around 50 major public companies and a slightly larger number of investing institutions, plus 500 pension funds. However, the institutional sample was heavily weighted in favour of investment trusts (35) and unit trusts (13) with only 7 members of the BMBA and 13 insurance companies. In spite of these deficiencies in the sample, the results bore out the commonly held view that insurance companies are the only category of investor which uses its votes on a regular basis, on mundane issues as well as contentious ones. Eleven of the 13 insurance companies said that they voted at all times. Of the 7 BMBA members only 1 voted at all times, accompanied by 1 of the 13 unit trusts and 10 of the 35 investment trusts. Somewhat surprisingly, 20% of the pension funds said that they voted at all times and 23% said that they never voted.

Responses from companies supported the evidence from the institutions. Very few institutions vote on mundane matters unless asked to do so, and quite a number of pension funds have a no–vote policy.

Reasons for not voting

There seem to be three main reasons why discretionary managers do not routinely exercise votes on behalf of their clients:

1 The administrative difficulties of coordinating votes on behalf of large numbers of clients are severe. This is particularly true because some clients are prepared to give full voting discretion, some are not prepared to give discretion at all and have to be asked on each occasion, while others give discretion but require consultation on contentious issues. Very considerable expense would have to be incurred by multi–client managers to organise voting on all issues, expense which might prove difficult to pass on to clients.

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2 Shareholding disclosure requirements are much more onerous where managers have the right to exercise votes. This reason, though powerful, may disappear as UK legislation on disclosure is brought into line with European legislation, and discussions on the subject are taking place with the DTI at present.

3 It is only seldom that issues emerge which clearly require the exercise of votes. It has often been argued, with some justification, that there is no need for institutional shareholders to exercise their clients' voting powers on routine matters of the kind familiar at every Annual General Meeting, provided that they always arrange for votes to be cast on important issues. The weakness of this argument is that failure to vote can be regarded as evidence of undesirable inertia – as it often is in the USA, where on average 5 times as many votes are cast as in the UK. If a board of directors knows that the company's institutional shareholders are going to vote on every motion at an AGM, it is more likely to believe that those institutions are taking a real interest in the company's affairs. The board will receive a clear message if the usual support is not forthcoming, and will be more likely to consult in advance about potentially controversial matters.

Should voting habits change?

After considerable discussion, the Association's Executive Committee has agreed that it is desirable for institutions to use the votes attributable to the portfolios under their control as frequently as possible. Although there may be arguments for voting only on matters of importance, the arguments for voting on all issues are at least as strong. It also seems that the pressure to vote on all issues can only increase, and it must be sensible to pre-empt further criticism. The Committee therefore suggests that all members should see whether they can reasonably organise themselves to vote on a regular basis, if they are not already doing so.

The Committee recognises that regular voting would be difficult for some members, especially those with large numbers of clients. Time and expense are bound to be involved in reviewing the motions put forward at company meetings and marshalling the appropriate votes, and in some cases the costs will be unacceptably high. However, clients are likely to take the view that managers should incur some expenditure, if necessary, in order to exercise votes. It seems reasonable to believe that virtually all clients of discretionary fund managers, if asked, will recognise the desirability of demonstrating their involvement in corporate governance by giving their managers voting discretion, even if many may wish to be consulted on take-overs and other contentious issues. We have

discussed this whole subject with The National Association of Pension Funds, which already has it under review and has recommended to its members that they should agree a voting policy with their managers.

Conclusion

The Executive Committee suggests that all members of the Association should review their present voting practices and, unless the costs involved would be unacceptable, so arrange matters, in consultation with their clients where appropriate, that votes are exercised as frequently as possible.

Routine voting ?
Opt-in ?

Trustees – mgrs – decn chain

Regulatory problem – if trustees make mgt. decns, should register with FIMBRA

C K R Nunneley
Chairman
26 June 1991

ifma

INSTITUTIONAL FUND MANAGERS' ASSOCIATION

COMMUNICATION OF BUSINESS PLANS & INSIDER DEALING

Background

1 Prices in a free market reflect all relevant available information – not merely hard facts about past performance but expectations about the future. Prices are determined as a result of a myriad of decisions to buy or sell made as market participants seek to gain advantage from what they consider to be their superior judgment or research.

2 Market participants will not have confidence in the market's operation if they feel that the market can be rigged by some participants deliberately restricting the flow of information or dealing on the basis of privileged information. It is a clearly established principle that a company's directors and staff, and its bankers and advisors, have a fiduciary obligation not to use confidential information obtained from their relationships with the company to deal in its shares. In addition, market and regulatory authorities – the London Stock Exchange, SIB, IMRO and other self-regulating organisations – have laid down rules to prevent abuses. Individual financial services companies also have internal rules governing their own dealing activities and those of their staff; these rules are aimed not only at ensuring compliance with legal and market requirements but at providing their customers with the assurance that they will be treated fairly and not disadvantaged by the company's activities on its own account.

3 Considerations of public interest have led to the introduction in many countries of criminal sanctions for the abuse of confidential information. In the UK the Insider Dealing Act 1986 makes it a criminal offence to deal on the basis of inside information. For an offence to be committed, the information must be confidential, usually seen as being the same as unpublished, and price sensitive. There is no need for the person dealing on the basis of the information to have any relationship of trust with the company whose shares he deals in. Both the person who provides confidential information with the knowledge or intention that it should be dealt on, and the person acting on it are liable to criminal sanctions. The EC Directive on Insider Dealing, which must be implemented by member states by June 1992, will further tighten the requirements on insider dealing.

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4 While abuse of confidentiality is usually clear cut, there remains a grey area on the border between inside and outside information where both company managements and fund managers and analysts have to exercise judgment as to what is permissible. Market rules can provide for the simultaneous publication to the market of hard information about past performance and a company's forecasts of future results, but market participants' perceptions about future prospects and their judgment of a company management's competence can only enter the market through the process of buying and selling shares. It is important for the market that there should be some incentive for market participants to form judgments about company prospects. It is also important for the market and for companies whose shares are quoted that these judgments should be soundly based.

Communications in Practice

5 Good communication between managements and those responsible for investment in a company's shares is vital to ensure that the latter understand the company. This helps to ensure that the share price fairly reflects prospects in the prevailing circumstances.

6 The fund manager's objective is to do the best he can for his clients, securing the balance of risk and return which is most appropriate for their needs. The use of legitimate information to form a judgment on a company and its prospects is central to his task. The raw material on which investment decisions are based is:

i company reports and accounts,

ii broker research,

iii published and unpublished economic, political and other information,

iv company visits by fund managers, and

v visits by company management to fund managers.

This note concentrates on points (iv) and (v), where a fund manager may receive information which puts him in an advantageous position compared to others.

7 The purpose of these visits is to improve the fund manager's knowledge of the companies in which he invests. Market trading on the basis of judgments formed from such visits helps to ensure that the share price fairly reflects the company's circumstances and to prevent the development of false markets based on inadequate or inaccurate information.

8 Information derived from company visits could give fund managers an unfair advantage against other investors and give rise to a charge of insider dealing. To avoid this, the onus is on the company not to give individual fund managers price-sensitive information which it has not made public.

There is growing pressure, however, on fund managers to take a greater interest in the management of the companies in which they invest, and company visits provide the opportunity for a two way flow of information between companies and their major investors. At these meetings precise forecasts are not made, though future prospects and strategy will be discussed and the fund managers will get a better feel for the company than they would by reading the Annual Report. However, when future prospects are being discussed, managements can be wrong and it is up to the fund manager to form his own view of the manager's judgement.

9 Many company managements actively seek to manage their company's share price. This is legitimate provided it is directed at ensuring that the share price properly reflects the company's prospects, and not at misleading the market. It is part of the fund manager's and analyst's job to judge to what extent the management's hopes (or fears) are justified by reality.

10 From time to time companies deliberately make large investors "insiders" to prevent them from dealing, sometimes over long periods, by giving them sensitive information without prior warning. This is an unacceptable practice and investors sometimes refuse to remain bound and choose instead to disseminate the sensitive information. It is also a risky practice from the company's viewpoint as any member of its management who reveals inside information with the object of influencing a fund manager's decision to buy or sell his company's shares could be personally liable to criminal sanctions, including imprisonment.

11 When a company is contemplating a price sensitive deal, for example a rights issue or an acquisition, it will sometimes sound out a few large investors with their prior agreement. In this event the recipients of the information are clearly placed in a privileged position, and not all large investors are prepared to be so placed; among those that are, practices differ. In some houses only one executive is involved; he becomes an insider, isolates himself from his colleagues and avoids any dealing in the stock or giving advice. A firm's need to protect its reputation means that abuses are extremely rare. Other houses will shut off all dealings in the stock, but this has to be done discreetly to

avoid stimulating interest. This sounding out process can be useful to the company and insider dealing regulations should not be allowed to prevent it.

12 Institutional investors prefer a regular flow of information from a company so that the share price adjusts continually to prevailing conditions. A steady trickle of relevant information from the company to the market is best, rather than sudden surges interspersed with periods of silence during which sensitive information accumulates. If a company is open about making public all relevant information about its business and prospects, everyone is better informed and there will be little or no privileged information for visitors to learn by accident. Clearly, some matters such as take-overs, rights issues and other exceptional developments can only be disclosed when the time is ripe. It is, of course, the responsibility of the company to manage the flow of information and competitive pressures are a factor it will have to take into account.

13 The free flow of information tends to minimise market anomalies. By dealing on the basis of opinions from company visits, a fund manager helps to iron out small anomalies. Bearing in mind that pricing can never be an exact science, this is in the general interest in that it should help to ensure that the share price reflects the company's prospects. There are times, however, when a significant change takes place in a company's circumstances and it is vital that a company should make a public announcement of any such change and not attempt to reveal it to just a small group of analysts or fund managers.

14 It can be difficult to define the exact border line between the use of legitimate information and insider dealing, since circumstances can be so different. In all cases an organisation's best interest is served by acting scrupulously to protect its reputation.

Conclusion

15 While there are different views even within the financial services industry about the provision of information in the period immediately prior to the publication of results, the majority view of the Association's Practice Committee is that a continued flow of information throughout the year offers the best way of preventing the creation of false markets and considerably reduces the opportunity for the unscrupulous to benefit from abuse of inside information. The Association believes that companies should see communications with

their larger investors and with analysts as part of a wider effort to communicate as much information as they reasonably can to all their shareholders. Every effort should be made to ensure that measures adopted by the relevant authorities in the UK and the European Community to prevent insider trading do not hamper communications between companies and their shareholders.

Where advice needed, then go to by s/hldrs.
Mosaic info. Ok, if you can make more of a piece of info than someone else that's Ok.
Cos stick worry about release of info.

D A ACLAND

23 July 1991

20% s/hldrs traceable as they don't trade.
S/term trading has no effect on relnships.
S/hldrs shld behave like owners rather than traders.
Can become more closely involved, consultation over appt heads
Quantity/qual mtgs. Listen to s/hldr views.
Inability make more effective requires both sides.

Sir Adrian

RECORD OF MEETING WITH MR CHARLES NUNNELEY, CHAIRMAN OF INSTITUTIONAL FUND MANAGERS ASSOCIATION (IFMA), ON 28 NOVEMBER 1991

Present:

Charles Nunneley
Sir Adrian Cadbury
Nigel Peace

Voting by Shareholders

Mr Nunneley said that he had received little feedback on his paper from members but had not detected any hostility. The initial draft had been watered down before it was finalised. Some investment managers did question the point of voting on other than obviously contentious issues, and anything the Committee could say to underline the importance of voting on a routine basis would be helpful. His understanding was that industrialists 'got a warm feeling' from knowing that shareholders were taking an interest.

2 Sir Adrian commented that Donald Brydon was pushing the view that before non-executives were appointed, there should be evidence of a certain degree of support for the appointment among the main shareholders. However this would be done by informal sounding out rather than by a formal vote.

3 Asked whether institutional shareholders should do more to take co-ordinated action with regard to companies in which they invested, Mr Nunneley said that he did not believe that shareholders should try to run companies as hands-on owners. There were ways of increasing involvement - consultation about appointments was an excellent example. Regular voting and regular meetings would increase shareholders' contribution and it was for companies to respond by taking notice of shareholders' views. Both sides (including the Investment Committees) could perhaps improve their ability to make contacts. But overall whilst there was room for improvement, it was limited.

Communication of Business Plans and Insider Dealing

4 Mr Nunneley said that again he had received little feedback. He had hoped for sensible comment as he felt the paper was somewhat thin, but the issues

were hard to get to grips with. The main conclusion was that there should be a steady flow of information from companies to the market.

5 Asked whether price sensitive information was obviously recognisable when one met it (paragraph 8), Mr Nunneley said that most analysts would recognise it although some companies might not. He understood Sir Simon Hornby's point that if there was to be a proper dialogue, companies should not have to be too careful about what they said. However Sir Simon perhaps took too restrictive a view of the legislation. In the US it was considered that communication of 'mosaic' information was legitimate and he would argue that the same should apply in the UK. (Mosaic information was information that was not price sensitive as such but could be price sensitive if the recipient was very knowledgeable about the company and could fit it into an overall picture.) This said, meetings between companies and fund managers should not be full of price-sensitive details, and they would not be if companies released information to the market regularly.

6 On Sir Simon's point that companies had to be very careful about disclosure of bad news, in case the media blew it up in a harmful way, Mr Nunneley commented that it did nobody any good for management to speculate about possible bad news. That would inevitably start hares that could not be stopped. Nevertheless his impression was that companies were still over-cautious about releasing information that would not bother anyone.

Insider Dealing Directive

7 Mr Nunneley said that great care needed to be taken over implementation of the directive. It would be quite wrong if it inhibited analysts from simply talking to companies, and put them at risk of a suit if they did (particularly if after the meeting they bought shares which later went up in price). [Information about the present position to be obtained from DTI.]

Tax incentives to hold shares long-term

8 With reference to John Smith's remarks at the recent PIRC conference, Mr Nunneley said that any form of artificial tax incentives not to trade shares would damage the market and ossify it. Short-term trading improved the efficiency of the market and there was no evidence at all that it affected companies' relationships with their major shareholders.

Auditors

9 Mr Nunneley said that IFMA took the view that the auditor should be appointed and have his remuneration fixed at the AGM. IFMA had recently responded to this effect to the APB. (Copy attached.)

N D P
2 December 1991

BARCLAYS de ZOETE WEDD

INVESTMENT MANAGEMENT LIMITED

R. Charlesworth Esq.,
Secretary,
The Auditing Practices Board,
P.O. Box 433,
Moorgate Place,
LONDON EC2P 2BJ

13th November 1991

Dear Mr. Charlesworth,

The Auditors' Report

On behalf of the Institutional Fund Managers' Association, I enclose our comments on the Auditing Practices Board consultative paper.

Yours sincerely,

D.A. ACLAND
Chairman
IFMA PRACTICES SUB-COMMITTEE

COMMENTS ON AUDITING PRACTICES BOARD CONSULTATIVE PAPER

General

IFMA supports and encourages the proposition that Auditors' Reports should be extended and clarified. Specific points arising from the consultative paper follow:-

Introduction

1-4 The responsibilities of Directors and Auditors are not well known by many shareholders and this needs to be rectified. It is, however, undesirable to publish formal paragraphs year after year in identical language, as this creates a very boring document. The possibility was mooted of covering this in a booklet which could be sent to interested parties, but an alternative and better solution would be to set out this information in a separate box immediately before the Auditor's Report. In this way the standard background information would be separated from the more important report itself and would not dilute its impact.

The Expectation Gap

8(a) The balance sheet - this will only provide a fair valuation of the reporting entity if the accounts allow shareholders the opportunity of judging the merits of the component parts. In particular, assets could be (a) intangible, e.g. Trademarks or Magazine titles with a saleable value; (b) tangible with an economic value but little resaleable value, e.g. specialised equipment; (c) tangible with resaleable value, e.g. property; (d) situated in a country whose exchange control prevented repatriation. This may require addressing as an accounting rather than an auditing standard, but should surely be noted in the Audit Report if the accounts as presented might mislead shareholders.

As to accuracy, the principle of materiality is accepted and widely understood. On the question of the continued existence of the entity, there is an obvious problem. Any serious doubt expressed by the auditor would hasten or ensure extinction. Equally, a clean report followed by failure is a source of great dissatisfaction. It should be possible to find a form of words which indicated the financial position of the entity was weak without

necessarily being at imminent risk and such a warning would concentrate minds to the benefit of all parties.

8(b) If Auditors do not examine a statistically satisfactory proportion of the company's transactions, this should be stated and not left silent.

8(c) On the level of assurance, this was covered in the paragraph on Auditors' Responsibilities in the Appendix example of an unqualified report. This is satisfactory provided an assessment of control systems is also included in the first paragraph listing specific responsibilities.

Language

16/17 Agreed that this should be as clear and unambiguous as possible and it should be immediately clear whether the report is unqualified. Any fudging of this issue devalues the position of the auditor.

Caparo

23 In order to reduce the moral hazard to which Auditors are exposed when, as in so many cases, they are effectively employed by a Board dominated by management, the following is suggested:-

Auditors should be appointed by shareholders as now and their remuneration disclosed and voted on at the AGM (not fixed by the Board). In addition, the non-Executive Directors or an Audit Committee with a majority of non-Executive Directors, should have a specific responsibility for ensuring:-

i. that the auditors have had full access to everything they need;

ii. that any queries raised by them have been answered and any control weaknesses corrected;

iii that the proposed remuneration being put to the meeting has their support.

These points should be publicly affirmed at the AGM by a non-Executive Director, preferably Chairman of the Audit Committee, with an opportunity given for shareholder questions. This would go some way towards strengthening the reliance shareholders should feel able to put on the auditors' report. However, there is a strong view that Caparo should be reversed and auditors should have a direct responsibility to shareholders. This whole area needs to be addressed, though it is outside the scope of this document.

The next steps

29 Answering the specific questions:-

a. Yes

b. Yes

c. See paragraph headed "Introduction." This should be included once in the Report & Accounts, suggested immediately before the Auditor's Report in separate box.

d. Yes, subject to adding control systems to Auditor's responsibilities, see comment paragraph 8(c).

e. No strong view, but should draw shareholders' attention to anything unusual.

f. It would be useful for other entities, e.g. major charities, where there is public interest, also for private companies where there are minority shareholders who could be oppressed.

D.A. ACLAND
Chairman
INSTITUTIONAL FUND MANAGERS' ASSOCIATION
Practices Sub-Committee

13.11.91