

Twenty-first century investment enquiry

A Proposal for the Establishment of

SHAREHOLDERS SELECT COMMITTEES

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Summary

Today's investment system was initiated by the Victorians with the Limited Liabilities Acts of 1858 and 1862. The Acts stimulated investment by making provision for the liability of investors to be limited to the amount of their investment and for them to have the right to attend and vote at an annual general meeting on the conduct of the company. The resulting increase in investment mainly by individuals provided a great benefit to the economy of the country.

The Victorian acts have been subject to many amendments but the principles have remained unchanged although the investment system has undergone a major evolutionary change. Originally the beneficial ownership of shares was mainly in the hands of individuals but today the majority of shares are held by corporate members. These corporate shareholders need to invest the funds which they receive from clients for provision of pensions and insurances etc. Consequently they have a fiduciary duty to their clients. However they rarely attend annual general meetings and they consider that the best interests of their clients are served by active participation in the stockmarket.

The paper identifies that as a result of this evolutionary change there is a lack of permanent commitment by both the management and the investors in companies. Such a commitment is essential for the creation of real wealth. A proposal to appoint a shareholders select committee in companies is made to heal the schisms which at present exist between investors and management. Consideration is given to the effect of the adoption of the proposal on the key areas identified in the terms of reference of the inquiry.

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The weakness in the Current Investment System

Companies create wealth by a process which involves customers, employees, managers and investors and it is only effective if there is confidence within each group of the other participants. The Victorians established the principles by which investors financed companies in the Limited Liabilities Acts of 1858 and 1862. The acts protected investors by limiting their liability to the amount of their investment and provided them with the right to attend an annual general meeting of shareholders to vote on resolutions controlling future activities of the company. Accountability ensured competent management and provided investors with confidence to provide the capital required for the industrial revolution taking place at the time. This common commitment between investor and management had a profound influence on the growth and prosperity of the United Kingdom during the 19th century.

The Victorian acts have been subject to many amendments and variations but the principles have remained unchanged. However the investment culture has evolved and changed dramatically. The Victorians identified investors as mainly individuals but today the majority of shareholders are institutions or corporate shareholders. By 1957 the beneficial ownership of shares by individuals had fallen to about 65% and by 1970 it had been further reduced to about 50%. Today it is probably less than 20%. Corporate shareholders behave quite differently from individual shareholders with the result that the provisions of the Victorian acts are no longer effective and in particular schisms have developed between management and investors.

Corporate shareholders invest the premiums they receive from clients for the provision of such services as pensions and insurance. Quite rightly in the interests of their clients they are concerned mainly with maintaining the capital value of their funds at the highest possible level. To this end they actively buy and sell their shares within the stockmarket. Undoubtedly an enhancement of their funds can be achieved by this process but of course any such rewards are at the expense of other investors. The process only redistributes that wealth which has been created by the success of companies. Nevertheless, corporate shareholding has resulted in very large volumes of shares being sold and bought and today we have a more volatile market than ever before. Although corporate shareholders rarely attend annual general meetings, many cast their votes by proxy and on most occasions these proxy votes are given to the existing management.

Thus the almost automatic casting of proxy votes in favour of the management has nullified the purpose of the annual general meeting as envisaged by the Victorians. Indeed there have been occasions when after vigorous debate the decisions of the meeting have been overridden by the majority votes of absent shareholders. There is the possibility that on some occasions proxy votes supporting management may have been cast by corporate shareholders who had decided to 'exit' by selling their shares. Nevertheless corporate shareholders have a fiduciary duty to their clients, and it is questionable if at some time in the future this duty is tested in the courts if the absence from annual general meetings and proxy

voting would be accepted. Undoubtedly such practice has resulted in the basic provisions of the Victorian acts for investors to protect their interests at an annual general meeting have been circumvented.

A further consequence of the majority votes being cast by proxy is that this majority is unaware of inadequacies which may have been displayed by management in responding to questions from participating shareholders. Such inadequacies can indicate a degree of incompetence in management which although being evident at the meeting may be allowed to develop as a result of the support of these proxy votes.

The absence of commitment by major shareholders at the annual general meeting has had consequences in the management of companies. Directors who manage the company traditionally had a lifetime career commitment to that company but we now see evidence that this commitment is being eroded as a result of the volatile changes in ownership which may occur. Directors feeling less secure take the short-term advantage of the support of large numbers of proxy votes to negotiate substantial severance packages. In many instances these severance packages are seen as a reward for failure with the result that the investment market is being brought into public disrepute as a vehicle for savings.

From the foregoing it is concluded that the Victorian acts which have served the country so well need to be replaced or modified in response to the evolutionary change in investment which has taken place. Central to this issue is the fact that the annual general meeting is no longer performing its proper function of bringing together management and investors in a joint commitment. This paper proposes that this goal can be achieved by a relatively minor modification Companies Act. This is more likely to be achievable than a revolutionary change in the Act itself.

The Proposed Solution

The relationship between shareholders and directors in a company has much in common with that between the cabinet and the House of Commons. The success of the system of Select Committees within Parliament provides a process where Members of the House of Commons can comment and influence the Government without detracting from the Government's ultimate right to manage the affairs of the country.

It is proposed that a Shareholders Committee should be established within each company whose shares are traded on the stockmarket. The committee should include representatives of each class of shareholders. That is individual shareholders and corporate shareholders but including employee shareholders in companies which have an employee share ownership scheme. Their duty however would be to act solely in the interests of the company and not as representatives of any particular section. Nominations would be invited for each category in accordance with the entries on the share register. In the event of the number of nominations in either category exceeding the number of vacancies on the committee an election should take place at the annual general meeting on the basis of each entry in the share register having one vote for each category on the committee.

The committee would have the right to request and receive any information which it decided it should consider in the interests of members. Proceedings would be confidential to members of the committee and they would report their findings to the Board of Directors with recommendations where appropriate. Additionally the committee would issue an annual report on its activities to shareholders for distribution with the Annual Report and Accounts. It would also have a duty to consider any resolutions posed for a general meeting and reporting its findings prior to such a meeting.

It will be apparent from the foregoing that the committee would not impinge on the rights of the directors to manage the affairs of the company nor on the authority of the annual general meeting of shareholders. However it would ensure that shareholders would be independently informed of the significance of any resolution put before a general meeting and would therefore restore the authority of such a meeting. Shareholders who were unable to attend the annual general meeting or indeed were unwilling would be able to cast their proxy votes on the basis of reasoned information. In the case of corporate shareholders this could be a means of discharging their fiduciary duty to clients.

At the same time the directors of the company would have the opportunity of consulting representatives of shareholders in developing any policy they wish to pursue. In such circumstances the directors could be more confident of being able to generate support in the long term for any such strategies they were proposing. In the event of a take-over bid the committee would be reluctant to recommend acceptance of the bid not accepted by management with the result that directors would have greater confidence in long-term career prospects. Indeed the report of the committee would in most circumstances create confidence of shareholders and thereby reduce the volatility of the market as a whole.

The form of the committee should be the subject of more detailed debate. Nevertheless, it may assist the enquiry in considering the practicality of the proposal if an example of the change in legislation was provided as in the draft Bill given in Appendix 1.

The Inquiry also requests information on key areas brief and comments on the impact of the proposal on each of these is given in Appendix II.

APPENDIX I

Shareholders' Select Committee

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BILL

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Make provision for each company to establish a shareholders' committee elected by its shareholders and to prescribe the responsibilities of the committee and the functions of the auditor, company secretary and solicitor of each company in relation to that committee.

TO BE ENACTED by the Queen's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:-

1. - The Companies Act 1985 shall be amended by inserting -

(a) after Part VI the following:

PART VIA

Shareholders' Select Committee

220(A) - (1) Every public company shall appoint a committee (to be known as 'The Shareholders' Committee') from among its members to provide regular, systematic and where necessary, urgent information, communication and consultation between the directors and the members of the company on matters of concern to them as members.

(2) Every public company shall, within three months of this Act coming into force, invite, in writing existing shareholders, and subsequently any new shareholders to submit nominations for election to the committee at the next annual general meeting, to hold office from the conclusion of the meeting until the conclusion of the subsequent annual general meeting at which the requirements of section 241 of this Act are complied with.

However, a director of the company or any person who has accepted a nomination for an appointment of a director of the company shall not be eligible for nomination to the Shareholders' Committee.

(3) The committee shall consist of equal numbers of persons nominated by corporate members of the company and of individual members who have been nominated by individual shareholders.

(4) Each nomination shall be supported by four members of the company and which will be accompanied by a statement from the nominee expressing willingness to hold office, shall be deposited with the company secretary by a date which he will announce and which will enable the nominations to be issued to members of the company at the time of the issue of the annual report.

(5) Appointment of the Shareholders' Committee of not more than fourteen and not less than six persons shall be by votes taken at the annual general meeting with each member having one vote to be cast in favour of a corporate nominee and one vote to be cast in favour of an individual nominee. Members shall

have the right to appoint a proxy in accordance with Section 372 of this Act.

(6) The Shareholders' Committee shall be constituted subject to the provisions of this section in accordance with Schedule 7A of this Act.

(7) The non-executive directors of the company shall be 'de facto' non-voting members of the Shareholders' Committee.

(8) The company secretary shall be secretary to the Shareholders' Committee and shall as soon as practicable transmit reports (including minority reports) prepared by or on behalf of the Shareholders' Committee, to the directors.

(9) The Shareholders' Committee shall have the right to request and receive any information which it decides that it should consider in the interest of members.

(10) The auditors, accountant, the secretary (or where applicable, joint secretaries) and the solicitor to the company, individually or jointly, shall forthwith refer to the Shareholders' Committee any matter of which they become aware which is a breach, or a wilfully intended breach, of the criminal law, of obligations under legislation including the Companies Act 1985 or of a fiduciary relationship owed to the company or to its members being a matter of concern to members of the company as members.

(b) in Section 235(5) (Directors Report) after 'Schedule 7' the words 'and Schedule 7A' and after the words 'and the involvement of employees in the affairs, policy and performance of the company the words ' and matters arising from time to time in and in connection with the Shareholders' Committee.

(c) insert after Schedule 7 the following Schedule -

‘SCHEDULE 7A’

Duties and proceedings of a Shareholders' Select Committee

(1) The Committee will meet as soon as is practicable after its appointment to elect a Chairman and Deputy Chairman from its members and to transact such other business as may be appropriate.

(2) The Chairman of the committee shall convene meetings of the committee as he considers appropriate or if requested to do so by any other member of the committee with adequate reason but in any event once a quarter.

(3) The secretary of the committee shall be responsible for the preparation and circulation of the minutes of the meetings of the committee which shall be confidential to members of the committee.

(4) The committee may act by a majority of its members present at a meeting but shall not act unless a majority of the committee are present.

(5) The committee shall consider any matter which it decides affects the interest of members of the company and after investigation will send a report to the directors of the company with recommendations where appropriate.

(6) The committee shall issue an annual report of its proceedings to members of the company for circulation to members at the time of the distribution of the annual report of the company.

(7) The committee shall have a duty to consider any resolution submitted to a general meeting of

members in accordance with Section 376 of this Act and to report their findings to members prior to the general meeting.

(8) Members of the committee shall not receive any remuneration for serving on the committee but shall be entitled to claim reimbursement for any expenses incurred in carrying out their duties.

(9) The office of a member of the committee shall be vacated if the member gives the secretary a signed notice of resignation, fails to attend three consecutive meetings without good reason, becomes bankrupt or compounds or arranges with his creditors, becomes mentally disordered, or is convicted of an indictable offence other than a motoring offence.

(10) Each member of the committee shall have an individual duty in proceedings to act solely in the interests of the company and it shall be an offence for any member to take an action contrary to this provision of the Act.

(11)(1) A vacancy occurring on the committee may be filled by a resolution of a meeting of the committee to appoint another member.

(2) The continuing members of the committee, if not less than two, may act notwithstanding any vacancy on the committee.

2. (1) This Act may be cited as the Shareholders Committee Act.
- (2) This Act shall come into force six months after its enactment.

APPENDIX II

Effects of the Adoption of the Proposal

The key areas of the inquiry identified in the terms of reference could be effected as follows.

Design of the Investment System

There could be a significant change in the investment culture. Investors, particularly corporate investors, would have an independent assessment of the competence of management in a company at the time of purchasing its shares. Further acceptable reports by the committee would maintain this confidence which would result in the subsequent retention of the shares. Thus the volatility of share ownership in the United Kingdom would be reduced.

Impact on the Company

The Shareholders Select Committee would become a forum for building a common commitment between management and investors on the policies being pursued by the company. It would create an environment of stable ownership of the company in which competent management would flourish.

Impact on the Pension Fund

The impact on the pension fund would be two-fold. Firstly a decrease in volatility of the shares within the fund would result directly in a reduction of the operating costs of the fund. Secondly the improvement in the economy (see below) would improve the return on the assets of the fund.

The report of the committees will improve the basis on which the pension providers carry out their fiduciary duty.

Impact on the Individual Saver

The morale of the individual saver has never been lower than today. The public perception is that savings invested are being used to maintain 'fat cat' salaries among managers and that investment products are subject to excessive management charges.

The adoption of the proposal will not have any immediate effect on this public perception. However as the consequences of this proposal become apparent this perception will change for the better.

Interventions

Interventions are necessary to set standards which are necessary to build public confidence in any system. No system is perfect however and interventions are inevitably required to rectify the consequences of any defects. The adoption of the proposal will reduce the number of occasions when such interventions are required.

Impact on the Economy

As this paper has stated, real wealth is only created by the success of companies. It is not created by

the entropy of repeatedly circulating shares amongst investors. Restoring the joint commitment of both investors and management in companies can only result in improving their performance and increasing the real wealth in the economy.