Corporate governance

CHAPTER CONTENTS

Introduction

Over the last 20 years or so, largely due to corporate scandals such as Enron, Parmalat and BCCI, there has been an explosion of interest in corporate governance. One could be forgiven for thinking that corporate governance is therefore a relatively new topic, but this is most certainly not the case. The term 'corporate governance' may be of relatively recent origin, but the theoretical foundations of the topic were being debated before the registered company even existed. However, whilst the topic itself is not new, it is only in the last two decades that the topic has started to receive the attention it has always deserved.

Historically, it could be argued that corporate governance formed an arcane and largely theoretical branch of company law. Today, it could legitimately be argued that company law is now a branch of corporate governance and, whilst the topic may have originated in a legal area, it has since spilled over to become a topic that also encompasses finance, accounting, economics, marketing and many other business disciplines.

Corporate governance is too large a topic to cover comprehensively in a single book, let alone a single chapter. Accordingly, our discussion will focus on a few key areas and developments. First, we will discuss what corporate governance actually is. Second, we will examine the evolution of the UK's corporate governance regime, noting especially the heavy reliance on non-legal reports and codes. Finally, we will analyse a number of corporate governance mechanisms that have risen to prominence in recent years.

What is 'corporate governance?'

Solomon correctly notes that the phrase 'corporate governance' has become 'one of the most commonly used phrases in the current global business vocabulary.'[1] However, despite the importance and prevalence of the phrase, there is no accepted definition as to what corporate governance actually is. Numerous definitions exist, but many of them are extremely broad and offer little guidance. For example, the Cadbury Committee (whose work is discussed below) defined corporate governance as 'the system by which companies are directed and controlled.'[2] Whilst this definition is doubtless correct, it is also so vague as to provide no real benefit whatsoever. Other definitions are overly narrow. For example, Schliefer and Vishny state that corporate governance 'deals with the ways in which suppliers of finance to corporations assure

[1] Jill Solomon, *Corporate Governance and Accountability* (4th edn, Wiley 2013) 3.
[2] Committee on the Financial Aspects of Corporate Governance, 'The Report of the Committee on the Financial Aspects of Corporate Governance' (Gee Publishing Ltd 1992) [2.5].

themselves of getting a return on their investment.'[3] Whilst this is a central theme of corporate governance, it is heavily shareholder and creditor focussed and conveys little about the myriad relationships involved in the modern company. Blair provides a more acceptable definition when she states that corporate governance is about 'the whole set of legal, cultural, and institutional arrangements that determine what public corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated.'[4] However, even this definition is too narrow as good corporate governance is important for private companies, as well as public companies.

It is therefore contended that corporate governance is not amenable to a short, pithy definition. This has been recognized insofar as several definitions exist that aim to provide more comprehensive, and lengthy definitions. For example, the Organization for Economic Co-operation and Development (OECD) states that:

Corporate Governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate Governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across the economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy.[5]

Mallin prefers not to define what corporate governance is, but rather lists the important features of corporate governance, namely:

- It helps to ensure that an adequate and appropriate system of controls operates within a company and hence assets may be safeguarded.
- It also prevents any single individual having too powerful an influence.
- It is concerned with the relationship between a company's management, the board of directors, shareholders and other stakeholders.
- It aims to ensure that the company is managed in the best interests of the shareholders and other stakeholders.
- It tries to encourage both transparency and accountability which investors are increasingly looking for in both corporate management and corporate performance.[6]

The above indicates that there is no single definition of corporate governance – indeed, it is probable that corporate governance has become too complex and broad to be amenable to a single definition. Therefore, I find it is preferable to examine corporate governance by focusing on a few key words or concepts, namely accountability and efficiency.

[3] A Schliefer and R Vishny, 'A Survey of Corporate Governance' (1997) Journal of Finance 737.
[4] MM Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (The Brookings Institute 1995) 3.
[5] G20/OECD, 'Principles of Corporate Governance' (OECD 2015) 10.
[6] Christine A Mallin, *Corporate Governance* (5th edn, OUP 2016) 8.

Accountability

The above definitions hint that one of the principal aims of corporate governance is to bring about accountability and transparency. Corporate governance should provide for a system whereby companies should be free to partake in risk-taking activity that can enhance societal wealth but at the same time, they should do it in such a way that encourages transparency in order that the regulatory authorities can ensure that corporations adhere to their legal requirements as well as providing interested parties with information concerning the company. However, bearing this in mind, consider the following example of one of the world's largest companies.

Example box – Royal Dutch Shell plc

The company that was to evolve into Royal Dutch Shell plc can trace its origins back to the mid-nineteenth century. Today, Shell is currently the largest oil and gas company in the world and the second largest company in the world. In 2008, it generated sales of over $458 billion (around £274 billion), made a profit of over $26 billion (around £15.5 billion) and owned assets totalling $278 billion (around £166 billion). It has over 100,000 employees and operates in over one hundred countries.

The question that has proved so difficult to answer is how can we make such massive entities accountable. Size is a fundamental factor. It is size that gives the company its power, and it is size that demands regulation. As companies grow, their ability to affect those around them also grows, and today's companies have grown to a massive scale, with many of the largest generating revenues that dwarf the gross domestic products of many countries. For example in 2015, Walmart generated revenue of $482 billion, which is greater than the gross domestic products of countries such as Denmark, Greece, Hong Kong, New Zealand and Norway. To put this in perspective, Apple's 2015 revenue was $234 billion. How such massive entities can be effectively regulated is a central theme of corporate governance.

Efficiency

Despite the current relevance of the topic (especially post-Enron), corporate governance is not a new topic. The term may be, but the subject is not. However, for many years, it existed as a somewhat obscure branch of corporate academia focusing on theoretical issues, and having little to do with the practical running of companies. Today, this is not the case. Corporate governance has become important in practice, and proposals must take into account the cost and effect on the company's efficiency. No matter how effective a mechanism may be, it will not be widely adopted by companies unless it can be shown to increase efficiency and is not unduly costly to implement. For example, as we shall see, many of the recommendations made by the Cadbury Committee (discussed below) were deemed desirable and implemented by many large companies. However, many smaller companies did not implement Cadbury's proposals on the ground that they were overly expensive and did not yield benefits proportionate to their costs. The Cadbury Report was the first in a series of reports that laid the foundation for the UK's system of corporate governance, and in order to understand how the current corporate governance system came to exist, it is important to understand the effect of the various codes and reports.

Corporate governance reports and codes

When we discussed company law in chapters 18 – 24, it was readily apparent that UK company law has historically been based around a central Companies Act, with the Companies Act 2006 being the current central piece of legislation. Conversely, legislation is largely absent from our UK corporate governance system, with the vast majority of corporate governance rules and principles deriving from a series of reports and codes. Many of these codes and reports were established, drafted and enforced by the professions that they were intended to regulate, leading to the UK system of corporate governance often being described as self-regulatory. Whilst this is true in part, it is also true to say that very few, if any, of the reports and codes that will be discussed are purely self-regulatory insomuch as there is usually some level of governmental involvement or support. For example, the Department of Trade and Industry (now replaced by the Department for Business Innovation & Skills) strongly backed the work of the Cadbury Committee, going so far as to provide the Committee's secretary and other support staff.

Within the last two decades, there have been a notable number of such reports and codes, so many in fact that a detailed study of all of them is beyond the scope of this text. However, an understanding of the principal reports and codes is essential if one wishes to understand how the current corporate governance regime came into being. We will therefore examine the principal reports and codes, beginning with the report that laid the foundations for the UK's 'self-regulatory' regime, namely the Report of the Cadbury Committee.

The Cadbury Report (1992)

In the 1980s and early 1990s, confidence in the financial aspects of the UK corporate governance regime dwindled following the insolvency of a number of companies that, prior to them becoming insolvent, had received clean reports from their auditors. Concern was expressed that the disclosure requirements were not being adhered to and the standard of audits was insufficient. The accountancy profession, along with the Financial Reporting Council and the London Stock Exchange, responded in May 1991 by setting up the Committee on the Financial Aspects of Corporate Governance, under the chairmanship of Sir Adrian Cadbury, the former chairman of Cadbury Schweppes plc (these committees are always known by reference to the surname of the person who chaired them, hence the Cadbury Committee). The importance of the Committee's formation was increased following a number of subsequent and prominent scandals, notably the Maxwell affair and the collapse of BCCI.

The Committee issued a draft report in May 1992 and its final report in December 1992. The Draft Report set out why good corporate governance was so important:

> The country's economy depends on the drive and efficiency of its companies. Thus the effectiveness with which the board discharge their responsibilities determines Britain's competitive position. They must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance.[7]

The Cadbury Committee sought to provide such a framework by issuing a Code of Best Practice (known as the Cadbury Code), which set out a series of broad principles that were supplemented by more detailed rules in the Committee's Final Report. A detailed discussion of the Code's recommendation is beyond the scope of this text, but prominent recommendations include:

[7] Committee on the Financial Aspects of Corporate Governance, 'The Financial Aspects of Corporate Governance: Draft Report' (Gee Publishing Ltd 1992) [1.1].

- The board should have at least three non-executive directors sitting on it,[8] and such directors should bring an 'independent judgment to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.'[9]
- Executive directors should play no part in the determination of their own pay and companies should therefore set up a remuneration committee, staffed wholly or mainly by non-executive directors.[10]
- To ensure that the auditor is independent, executive influence in the appointment of the auditor should be removed. Companies should therefore set up audit committees, staffed wholly or mainly by non-executive directors who would be responsible for nominating an auditor.[11]
- To avoid an over-concentration of power, the roles of chairman and chief executive should be split.[12]
- Directors' contracts of service should not exceed three years.

Self-regulation lay at the heart of the Committee's recommendations and the Committee actually recommended that the Code should not have statutory backing. However, it did recommend that listed companies should include a 'statement of compliance' as part of their annual report, in which would be stated whether or not the company had complied with the Code of Practice and, if the Code has not been complied with, the company should provide clear reasons why it had failed to comply. This recommendation was adopted and made part of the Stock Exchange's *Yellow Book*.[13]

Whilst there was nothing radical in Cadbury's recommendations and there was a general feeling that the Committee had 'played it safe,' it cannot be denied that Cadbury made a significant contribution to the development of good corporate governance in the UK. Firstly, in the years following the publication of the Cadbury Code, a significant body of research developed indicating high levels of compliance with the Code's recommendations[14] (although, due to the costs of complying with the Code's recommendation, compliance amongst smaller companies was relatively low). Secondly, Cadbury showed that self-regulation was preferable to statutory regulation and, in that respect, Cadbury laid the foundations for our current system of corporate governance and provided the impetus for future reports. We did not have to wait long, when in 1995 the Greenbury Report was published.

The Greenbury Report (1995)

In late 1994, British Gas plc proposed changes to the remuneration packages of its senior executives. One such change resulted in Cedric Brown, the then CEO, receiving a pay increase of 70%, thereby increasing his annual remuneration to £475,000. Following public condemnation, the media latched onto the controversy with headlines such as 'Derailing the Gravy Train,'[15] 'Executive Gluttony Under Attack'[16] and 'Fat Cats in the Dock.'[17] The then Prime Minister, John

[8] ibid [4.11].
[9] ibid.
[10] ibid [4.42].
[11] ibid [4.36].
[12] ibid [4.9].
[13] The *Yellow Book* provided a body of rules that listed companies had to comply with. Today, these rules can be found in the *Listing Rules*, which exist under the purview of the Financial Reporting Council.
[14] See *e.g*. MJ Conyon and CA Mallin, 'A Review of Compliance with Cadbury' (1997) 2 Journal of General Management 24.
[15] (1995) *Sunday Times* January 22nd.
[16] (1994) *Financial Times* November 26/27th at 3.
[17] (1995) *Economist* March 4th.

Major, indicated that statutory changes may be required, but the government was reluctant to act without expert advice. Accordingly, in January 1995, the Confederation of British Industry (the body that speaks on behalf of the business community) set up a study group to examine the issue, under the chairmanship of Sir Richard Greenbury (the then CEO of Marks and Spencer plc). The Greenbury Committee published its report[18] in July 1995.

Like Cadbury, Greenbury favoured self-regulation as opposed to statutory regulation and, like Cadbury, it set out a Code of Practice, supplemented by specific recommendations in the Report itself. Notable recommendations include:

- That companies set up an independent remuneration committee to determine directors' remuneration,[19] and the committee should consist exclusively of non-executive directors.[20]
- Existing disclosure requirements found in the Companies Act 1985 (now repealed) are 'not sufficient'[21] and more extensive disclosure requirements were established that would form part of the annual report.
- That directors' service contracts be for a maximum duration of one year.[22] If a director has a service contract that is longer than one year in length, this should be disclosed in the annual report and reasons provided for the increased length.

Like Cadbury, compliance with the Greenbury Code became a Stock Exchange listing requirement. However, unlike Cadbury, there was grave concern regarding the level of compliance,[23] especially in relation to the increased disclosure requirements. Accordingly, the government indicated that it intended to pass subordinate legislation setting out increased disclosure requirements. This legislation and its subsequent incorporation into the Companies Act 2006 will be discussed later in this online chapter when we discuss executive remuneration as a corporate governance mechanism.

The Hampel Report (1998)

The Cadbury and Greenbury committees were set up following high-profile events that raised concerns about specific areas of corporate governance. In other words, the setting up of both committees was reactive and both committees operated within a specified ambit. They were never intended to be definitive examinations of our corporate governance system – they merely focussed on the immediate problems at the time. Implicit recognition of this can be seen in that both committees recommended that a successor committee be established to monitor compliance and to provide a more general examination of our corporate governance system.[24] This committee, under the chairmanship of Sir Ronald Hampel (the then chairman of Imperial Chemical Industries plc), was formed in November 1995 and issued its final report in 1998.[25] The

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[18] 'Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury' (Gee Publishing Ltd 1995).
[19] ibid, [4.3].
[20] ibid, [4.8].
[21] ibid, [5.2].
[22] Ibid, [7.13].
[23] See *e.g.* PriceWaterhouseCoopers, 'Monitoring of Corporate Governance Aspects of Directors' Remuneration' [Online] Available <http://webarchive.nationalarchives.gov.uk/20070603164510/http://www.dti.gov.uk/cld/pwcrep.pdf>; DTI, 'Directors' Remuneration Report Regulations 2002: Regulatory Impact Assessment' [Online] Available <http://webarchive.nationalarchives.gov.uk/20070603164510/http://www.dti.gov.uk/access/ria/pdf/directors-remuneration.pdf>
[24] Committee on the Financial Aspects of Corporate Governance, 'The Report of the Committee on the Financial Aspects of Corporate Governance' (Gee Publishing Ltd 1992) [3.12]; 'Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury' (Gee Publishing Ltd 1995) [3.11].
[25] Committee on Corporate Governance, 'Final Report' (Gee Publishing Ltd 1998).

Committee's remit was much broader than that of Cadbury and Greenbury and this is reflected in the Final Report, which sets down a broad series of principles, as opposed to a list of prescriptive rules. As the Final Report stated:

> Good corporate governance is not just a matter of prescribing particular corporate structures and complying with a number of hard and fast rules. There is a need for broad principles. All concerned should then apply these flexibly and with common sense to the varying circumstances of individual companies. This is how the Cadbury and Greenbury committees intended their recommendations to be implemented... Having reached broad conclusions on the nature and purpose of corporate governance, we have identified a small number of broad principles - some already identified in the Cadbury and Greenbury reports - which we hope will command general agreement.[26]

Whereas Cadbury and Greenbury were designed to focus on preventing specific corporate governance abuses, Hampel was based on promoting good corporate governance and the contribution that good practices could provide. As a result, it has been described as 'one of the most balanced UK reports on corporate governance.'[27] Prominent recommendations that built upon Cadbury and Greenbury included:

- Nomination committees should be set up to improve the independence and transparency of the selection of directors.[28]
- Newly appointed directors should receive appropriate training.[29]
- Non-executive directors should make up at least one-third of the board.[30]
- Directors should submit themselves for re-election at an interval of no more than three years.[31]
- A significant proportion of a director's remuneration should be linked to company performance.[32]
- The remuneration disclosure requirements should be simplified in order to be more accessible to a layperson.[33]
- Institutional shareholders have a responsibility to make considered use of their votes.[34]

The Hampel Committee also produced a draft Code of Practice that would combine the recommendations of Cadbury, Greenbury and Hampel into a single Code. This draft Code was passed to the London Stock Exchange for approval, and following some minor amendments, the Combined Code on Corporate Governance (usually know as the Combined Code) was issued in June 1998.

The Combined Code (1998)

As stated, the original version of the Combined Code merged the best practices contained in Cadbury, Greenbury, and Hampel and, as we shall see, it has since been updated three times to

[26] ibid [1.11] and [1.20].
[27] JJ du Plessis, J McConvill and M Bagaric, *Principles of Contemporary Corporate Governance* (Cambridge University Press, Melbourne, 2005) 305.
[28] Committee on Corporate Governance, 'Final Report' (Gee Publishing Ltd 1998) [2.7].
[29] ibid, [3.5].
[30] ibid, [3.14].
[31] ibid, [3.21].
[32] ibid, [4.6].
[33] ibid, [4.16].
[34] ibid, [5.7].

accommodate further reports. Responsibility for reviewing and updating the Code initially rested with the London Stock Exchange, but it has since been passed to the Financial Reporting Council.

The Combined Code followed on from the approach advocated by Hampel, namely to allow companies to establish their own corporate governance practices based on broad principles it laid down. The Code was split into two sections. Section 1 contained those principles and recommendations relating to directors, remuneration, accountability and audit, and relations with shareholders. Section 2 contained those principles and recommendations relating to institutional shareholders. Listed companies were not required to adhere to the requirements in the Code, but they were required to include the following in their annual reports:

- A statement as to how the company has applied the principles found in Section 1 of the Combined Code.
- A statement as to whether the company has complied with the principles set out in Section 1. If the company has not complied with any principles, it must identify those principles and explain why it has not complied with them.

The Turnbull Report (1999)

Principle D.2 of the original 1998 Combined Code provided that '[t]he board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.' With the agreement of the London Stock Exchange, the Institute of Chartered Accountants in England and Wales (ICAEW) decided to provide guidance to listed companies on how best to comply with the Code's requirements relating to internal control. Accordingly, the ICAEW set up a committee under the chairmanship of Nigel Turnbull (an executive director of the Rank Group plc) to draft a report offering such guidance, and the Turnbull Committee published its final report in September 1999.[35]

The Turnbull report defined an 'internal control system' as those policies, processes, tasks, behaviours and other aspects of a company that, taken together:

- facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives.
- help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation.
- help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.[36]

Like the reports that preceded it, the guidance contained in the Turnbull Report was not prescriptive and instead contained a series of broad recommendations and principles that would enable companies to devise their own effective system of internal control. In this sense, the Turnbull Report has been described as 'revolutionary'[37] insomuch as no other country has a specific document devoted to promoting good practice in internal control.

[35] Institute of Chartered Accountants in England and Wales, 'Internal Control: Guidance for Directors on the Combined Code' (ICAEW 1999).
[36] ibid [20].
[37] Jill Solomon, *Corporate Governance and Accountability* (4th edn, Wiley 2013) 58.

The Myners Report (2001)

In his Budget of 2000, the then Chancellor, Gordon Brown, announced that he had asked Paul Myners (the then chairman of Gartmore Investment Management) to investigate whether there existed any factors distorting the decision-making of institutional investors. His final report was published in March 2001[38] and made a number of recommendations aimed at improving the contribution institutional investors can make to good corporate governance.

The Smith Report (2003)

The Cadbury Committee recommended that listed companies should establish an audit committee to ensure that a company's internal audit function operated effectively and that an independent and effective statutory auditor was appointed. The collapse of Enron and the eventual demise of its auditor, Arthur Andersen, provided stark proof of the consequences of an ineffective audit and the impetus to strengthen existing rules. Shortly after the Enron scandal, the UK government asked the Financial Reporting Council to establish a group to look into improving the Combined Code's recommendations regarding audit committees. The group, chaired by Sir Robert Smith (the then chairman of The Weir Group plc), published its report in January 2003.[39] The Report set out the importance of the audit committee:

> While all directors have a duty to act in the interests of the company, the audit committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control.[40]

The Report then recommended a number of additions to the Combined Code to strengthen the rules relating to audit committees, including:

- The board should establish an audit committee of at least three members, all of whom should be non-executive directors.
- The main roles and responsibilities of the audit committee should be set out in writing.
- The chairman of the audit committee should be present at the AGM to answer questions.

The Higgs Report (2003)

Many of the reports and codes discussed in this chapter stress how important non-executive directors are to good corporate governance. However, a number of high-profile corporate scandals had occurred (notably Enron and Parmalat), the blame for which had partly been laid at the feet of non-executive directors who had failed to exercise competently their monitoring function. It is therefore unsurprising that a report was commissioned that focused solely on non-executive directors. Derek Higgs (a senior and well-respected businessman who held posts at a number of companies including Prudential and Alliance & Leicester) was asked by the government in 2002 to conduct a review on the role and effectiveness of non-executive directors and his report was published in January 2003.[41]

Notable recommendations of the Higgs Report include:

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[38] Paul Myners, 'Institutional Investment in the United Kingdom: A Review' (HM Treasury 2001).
[39] 'Audit Committees: Combined Code Guidance' (FRC 2003).
[40] ibid [1.5].
[41] Derek Higgs, 'Review of the Role and Effectiveness of Non-Executive Directors' (DTI 2003).

- The report offered a definition of the role of a non-executive director and recommended that this definition be made part of the Combined Code.[42]
- At least half the board, excluding the chairman, should consist of independent non-executive directors.[43]
- Higgs noted that the Code's definition of 'independence' offered little guidance, and so the report offered a detailed test to determine a director's independence.[44]
- A company's non-executive directors should meet at least once a year without the chairman or executive directors present, and it should be noted in the company's annual report whether or not this meeting has taken place.[45]
- Newly appointed non-executive directors should undertake a comprehensive, formal and tailored induction process.[46]
- Higgs endorsed the recommendations made in the Smith Report[47] (discussed above).

A number of the recommendations made by Higgs were regarded as controversial and were bitterly opposed by certain groups. Despite this, the majority of Higgs' recommendations made their way into the Combined Code when it was updated in 2003 (see below).

The Tyson Report (2003)

The Higgs Report noted that individuals from non-commercial backgrounds could provide a valuable contribution to the boardroom and that directors should be appointed from a wider pool than is currently the case. The Report went on to state that 'a group of business leaders and others will be formed to help bring to greater prominence candidates from the non-commercial sector who could have the skills and experience to make an effective contribution to the boards of listed companies.'[48] Professor Laura Tyson, Dean of the London Business School, was invited by the Department of Trade and Industry to chair this group and it presented its report in June 2003.[49]

The Tyson Report stated that 'many boards lack a diverse range of skills, experiences and perspectives that could help them address the diverse challenges confronting their companies'[50] and that '[e]xperts on corporate governance agree that the best boards are composed of an appropriate mix of individuals with different skills, experiences and knowledge.'[51] The Report therefore argued that UK companies could benefit greatly from having greater diversity in their pool of non-executive directors and discussed in detail how companies could broaden the sources of non-executive director talent.

[42] ibid [6.7].
[43] ibid [9.5].
[44] ibid [9.7] to [9.14].
[45] ibid [8.8].
[46] ibid [11.1].
[47] ibid [13.7].
[48] Derek Higgs, 'Review of the Role and Effectiveness of Non-Executive Directors' (DTI 2003) [10.32].
[49] Tyson Task Force on the Recruitment and Development of Non-Executive Directors, 'The Tyson Report on the Recruitment and Development of Non-Executive Directors' (London Business School, 2003).
[50] ibid 6.
[51] ibid.

The Combined Code (2003, 2006 and 2008)

As stated above, the first Combined Code was created in 1998. The above subsequent reports and other events have resulted in the need to periodically update the Code. To date, three major updates have taken place, namely in 2003, 2006 and 2008.

2003

The recommendations of the Higgs and Smith Reports necessitated an update of the Code and the first major update occurred in July 2003. The principal updates contained in the 2003 Code included:

- At least one-half of the board should comprise of independent non-executive directors (the 1998 Code recommended one-third).
- One of the non-executive directors should be appointed as the company's senior independent director (SID). The SID would be available to shareholders, should they have concerns that have failed to be resolved through normal channels.
- Non-executive directors should be appointed for specific terms. Any term beyond six years (*e.g.* two three year terms) should be subject to a particularly rigorous review. A non-executive director may serve for longer than nine years, provided that he is re-appointed annually. Serving longer than nine years may affect the ability of the non-executive director to be classified as independent.
- The board should not agree to a full-time executive director taking more than one non-executive directorship in, or chairmanship of, a FTSE 100 company

2006

In 2005, the Financial Reporting Council carried out a review of the Combined Code, which led to an updated Code being issued in June 2006. The 2006 Code contained several notable changes, including:

- The company's chairman may be a member of, but may not chair, the remuneration committee, providing that he was considered independent upon his appointment as chairman.
- The introduction of a 'vote withheld' option on proxy appointment forms. This option is designed for those shareholders who have concerns over a particular candidate, but do not wish to vote against him. Such a vote is not a vote in law and will not be counted in the calculation of votes for or against the resolution.

2008

In 2007, the Financial Reporting Council engaged in another review of the Code, with led to an updated Code being issued in June 2008. The two notable changes were:

- The prohibition on an individual chairing more than one FTSE 100 company has been removed.
- The company's chairman may be a member of, but may not chair, the audit committee, providing that (i) the company is a 'smaller' company,'[52] and; (ii) he was consider independent upon his appointment as chairman.[53]

[52] The Code defines smaller companies as those below the FTSE 350.
[53] Financial Reporting Council, 'The Combined Code on Corporate Governance' (FRC 2008) Principle C.3.1.

The Walker Review (2009)

The Walker Review was established in early 2009 to investigate standards of corporate governance in UK banks and other financial institutions following the banking crisis. The Report,[54] which was published in November 2009, broadly supported the comply or explain approach adopted by the Combined Code, but did note a number of corporate governance failures, notably in relation to board effectiveness and accountability, and the stewardship role on large institutional investors.

The UK Corporate Governance Code (2010, 2012, 2014 and 2016)

The Combined Code was updated for a fourth time in May 2010 and was renamed the UK Corporate Governance Code. Notable changes included:

- All directors of FTSE 350 companies should be put forward for re-election every year;
- The introduction of new principles relating to the leadership of the chairman, the responsibilities of non-executive directors, and the time commitment of directors;
- Performance-related pay should be aligned to the long-term interests of the company.

The Code was first updated in 2012 and notable amendments and additions included:

- Boards should set out in their annual reports why they consider the annual report to be fair, balanced and understandable;
- The remit of the audit committee will be extended to cover consideration of the entire annual report, with a view to determining whether it provides the necessary information for stakeholders to assess the performance and prospects of the company;
- FTSE 350 companies will be expected to put the audit contract out to tender at least every ten years.

The Code was updated again in September 2014, with key changes including:

- Additional recommendations added regarding risk management and internal control;
- Greater emphasis on putting in place remuneration packages that are consistent with the long-term success of the company. Companies should also put in place systems that allow them to recover or withhold variable pay when appropriate to do so;
- When publishing general meeting results, companies should explain how they intend to engage with shareholders when a significant percentage of them have voted against a resolution.

The Code was updated again in June 2016, with most of the changes relating to enhancing auditor independence and ensuring the effectiveness of the audit committee (for example, the Code now states that audit committees should have competence relevant to the sector in which the company operates).[55] The FRC have pledged not amend the Code further until at least 2019.

[54] Sir David Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities' (HM Treasury 2009).

[55] FRC, 'The UK Corporate Governance Code' (FRC 2016) [C.3.1].

The UK Stewardship Code (2010 and 2012)

As is discussed later, concerns have exited regarding the stewardship role undertaken by institutional investors. To encourage such investors to engage more with their investee companies, in July 2010 the FRC published the UK Stewardship Code,[56] which contained a series of principles aimed at encouraging greater engagement. The Code was updated in 2012.

The Davies Report (2011 and onwards)

The lack of diversity on UK boards has long been a cause of concern, especially the low number of women on UK boards. The Combined Code encouraged diversity, but little was achieved. Impetus for reform came in February 2011 when Lord Davies launched an independent review into women on boards. Lord Davies' review began by stating that women only accounted for 12.5 per cent of all directors of FTSE 100 companies and that, at the current rate of change, it would take 70 years to achieve gender-balanced boards.[57] To combat this inequality, the Review made a number of recommendations:

- All Chairmen of FTSE 350 companies should set out the percentage of women they aim to have on their boards in 2013 and 2015;
- FTSE 100 companies should aim for a minimum of 25 per cent female representation;
- Quoted companies should disclose each year the proportion of women on their board;
- The FRC should amend the UK Corporate Governance Code to require listed companies to establish a policy concerning boardroom diversity. The FRC has indicated that this requirement will be incorporated into its revised Code by October 2012.

Since the original Davies Report, follow-up reports have been published annually. There can be no doubt that gender diversity has notably improved since the publication of Lord Davies's 2011 report, with Lord Davies's 25 per cent goal being successfully reached. The Woman on Boards Review Five Year Summary states that women made up 26.1 per cent of FTSE 100 boards.[58]

However, issues remain, with the principal issue being what Lord Davies has termed 'the executive pipeline challenge.' The vast majority of recent female appointments have been to non-executive roles, with very few appointments to more influential executive positions. Women only occupy 9.6 per cent of executive directorships in FTSE 100 companies[59] and the increase in the number of female executives has been slight. In 2010, there were 18 female executives on FTSE 100 boards – as of October 2015, that figure has only risen to 26 (compared to 244 male executives). Further, the FTSE 100 has only 5 female CEOs and only 3 female chairmen. To combat this, Lord Davies recommended that FTSE 350 CEOs should set out the percentage of women they aim to have on their executive committees in 2015.[60] There is little indication that this has had an effect, and the level of women being appointed to executive positions is still disconcertingly low.

That issues remain was recognized by Lord Davies. In his five year summary report, he stated that 'with a longer term aim of achieving better gender balance on FTSE Boards, further work

[56] FRC, 'The UK Stewardship Code' (FRC 2010).
[57] Lord Davies, 'Women on Boards' (February 2011) 3.
[58] Women on Boards Davies Review, 'Improving the Gender Balance on British Boards (2015) 6.
[59] ibid 34.
[60] Lord Davies, 'Women on Boards' (2013) 7.

and a renewed focus is required'.[61] To combat the deficiencies noted above, the report put forward a further set of recommendations, including:

- FTSE 350 boards should aim for a minimum of 33 per cent female representation by the end of 2020.
- FTSE 350 companies should focus on fundamentally improving female representation of women on the executive committee and in senior leadership positions. Stakeholders should work together to increase the number of women appointed to the roles of chairman, Senior Independent Director, and executive positions.
- All FTSE listed companies should assess gender balance on their boards and take prompt action to address any short fall.

The report also recommended that an independent steering body is re-convened to support business in achieving the above goals and to report on progress. This body would review these new recommendations and publish detailed comments. This body was set up in February 2016 and Sir Philip Hampton (currently the chairman of GlaxoSmithKline plc) was appointed as its chair.[62] This new body has yet to report.

Corporate governance mechanisms

It can be seen that a crucial role of the non-legal reports and codes discussed previously is to recommend the creation of, and to put in place principles governing, mechanisms designed to improve standards of corporate governance. Certain corporate governance mechanisms are largely legal in nature and have been discussed in the textbook namely encouraging shareholder democracy through the use of company meetings and the ability to hold directors accountable by removing them under the Companies Act 2006, s 168. In this chapter, we will focus on a number of mechanisms that are principally regulated by non-legal means, namely:

- Directors' remuneration
- Institutional investors
- Non-executive directors
- The market for corporate control

Directors' remuneration

As noted when we discussed the work of the Greenbury Committee, directors' remuneration became a prominent governance issue in the mid-1990s following the pay increase of Cedric Brown, the then CEO of British Gas plc. Brown was one of many directors of newly privatised utility companies who were receiving large remuneration packages, compared to the more modest salaries they were being paid when the relevant utilities were under state control. The media latched onto the issue and public condemnation was levelled against these so-called 'fat cats.' In particular, a widespread concern was that directors' pay was not linked to performance and many directors were earning significant sums whilst their companies struggled to make a profit.

As a result, shareholders, the public, politicians, trades unions, and the business community in general are now all showing marked interest in directors' remuneration as a governance issue. It

[61] ibid 28.
[62] See <https://www.gov.uk/government/news/new-chair-and-deputy-chair-of-women-on-boards-review-will-champion-female-executives>.

should be noted that the remuneration debate has been ongoing in the USA for much longer than in the UK and, as we shall see, US executives are paid considerably more than their UK counterparts. However, even though the debate in the UK has been ongoing for around fifteen years, much has been done in this time to better regulate directors' remuneration. In fact, it is perhaps true to say that, due to the media attention that directors' remuneration has attracted, it is the governance issue that has received most attention from academics, the business community and the government.

The work of the Greenbury Committee has already been discussed, so this section will focus on other initiatives in relation to directors' pay. However, before these initiatives can be discussed, it is important to understand the complexities of a modern remuneration package.

Methods of remuneration

Modern remuneration packages can be extremely complex and can consist of a number of components. In this section, we will discuss the principal components that may be part of a modern remuneration package.

The most obvious form of remuneration is a salary, the amount of which is usually specified in the director's service contract, although it may be set elsewhere (for example, in the company's articles).[63] Although it was Cedric Brown's £475,000 salary that ignited the issue, his salary is by no means the highest. In fact, compared to some, his is positively modest. In the same year, Peter Wood, a director for the Royal Bank of Scotland, was paid £18,473,169, an increase of 201.8% on the previous year. More startling was the pay increase of Octov Botnar, a director for the Automotive Financial Group, whose pay rose to £3,809,000, an increase of 2,830%.

One possible reason why Cedric Brown was vilified was that, at the time of his pay increase, British Gas was making hundreds of employees redundant and cutting the wages of many more. The relative position of senior management and their employees should be borne in mind when determining remuneration. A 1995 poll revealed that 90% of UK adults believed that inordinate rises in executive pay could reduce employee morale.[64] The Greenbury Committee recognised this when it urged remuneration committees to take into account rank-and-file wage levels when formulating executive pay.[65] This recommendation is now part of the UK Corporate Governance Code.[66]

However, when one compares the pay of senior executives and their workforce, it is clear that a sizable gap exists. In 2008, Xstrata plc, a global mining company listed on the London Stock Exchange was revealed to be the most expensive board in the UK, paying its directors a combined total of £30 million. Xstrata's CEO Mick Davies was paid £13.9 million, meaning that he earned 424 times more than the average Xstrata employee (around £33,000 per year). The largest discrepancy was found in Lonmin plc, a large company specialising in the production of platinum, where its former CEO, Brad Mills, earned just over £8.2 million, 790 times more than the £10,410 that Lonmin's employees were earning on average.

Such inequalities of pay are accentuated when companies move their manufacturing base to countries where rates of pay are low, as the following US example demonstrates.

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[63] It is inadvisable for a director to have his pay set by the articles, as the articles can be changed by the passing of a special resolution, whereas a term of his service contract cannot.
[64] *Salary Rises Among Leading Company Chiefs Reached 12%* (1995) *The Times* July 14th.
[65] 'Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury' (Gee Publishing Ltd 1995) [6.13].
[66] Financial Reporting Council, 'The UK Corporate Governance Code' (FRC 2016) D.1 Supporting Principles.

Example Box – Allied Signal
In 1993, Lawrence Bossidy, CEO of US firm Allied Signal, announced on national television that his company would not shift jobs from the United States to Mexico if the North American Free Trade Agreement (NAFTA) was passed. NAFTA is an organization dedicated to eliminating tariffs between the US, Canada and Mexico. Many US employees feared that once tariffs are removed, their jobs would be taken by Mexican employees willing to work for much less. Within two years on NAFTA's passage, AlliedSignal boasted the highest number of petitions to the Department of Labor claiming job loss due to NAFTA. In 1995, Allied Signal's Mexican plant paid its employees \$0.82 per hour following the peso devaluation. At that rate, Allied Signal's 3,800 Mexican employees earned a combined annual total of about \$7.8 million - less than Lawrence Bossidy's total 1995 compensation of \$8.4 million.

One would suspect that this imbalance would be partially evened out by the introduction of the national minimum wage. The Trades Union Congress argued for a minimum wage of around £4.60 per hour. The Confederation of British Industry, in its evidence to the Low Pay Commission, argued for a national minimum wage of between £3.10-20 per hour. The decision to set the initial rate at £3.60 for workers aged 18-21 was according to the CBI 'towards the higher end of what is acceptable to business.'[67] However, if one examines the earnings of leading CBI members at the time, it becomes clear that they value themselves much more highly than those earning the minimum wage.

Sir Clive Thompson, President of the CBI when the national minimum wage was introduced, earned £446.34 per hour as CEO of Rentokil Initial - 129.5 times the minimum wage that the CBI believed was 'towards the higher end of what is acceptable to business.' Similar trends were present among other CBI members. It should be remembered that the CBI instigated the Greenbury study into executive pay and yet the committee themselves are amongst the highest paid. In 1995, Sir Richard Greenbury himself earned £1,156,010, excluding his non-executive directorships of Lloyds Bank and Zeneca.[68] It is therefore no surprise that this situation has been described as 'a case of putting Dracula in charge of a blood bank.'[69] Whatever the issues involved, the major point is that inordinate executive pay rises can cause dissatisfaction amongst the rank-and-file workers. Consequently, morale and productivity may suffer.[70] Further, excessive executive earnings can complicate salary negotiations. In 1995, Barclays Bank experienced a period of severe employee dissatisfaction. During bargaining, which was marked by strike activity, Barclays employees sought to justify their wage demands by drawing attention to the substantial pay increases that the Barclays board had received.[71]

The problem with a salary as a form of remuneration is that the director will receive it irrespective of his performance. Therefore, it could be argued that a director whose remuneration derives solely from his salary has no incentive to devote 100 per cent effort, as such a director will still receive his full salary even if he shirks some of his responsibilities. Accordingly, it has become increasingly popular for a portion of a director's remuneration to be in some way tied to his performance. This can be done in a number of ways (for example, the payment of an annual bonus if certain performance targets are met), but one of the most

[67] Quoted in Labour Research Department, 'Bosses Rate Themselves Highly' (1998) 87 Labour Research 9, 9.
[68] Labour Research Department, 'High Pay: Leading By Example' (1995) 84 Labour Research 17, 17.
[69] Ibid.
[70] LJ Barris, 'The Overcompensation Problem: A Collective Approach to Controlling Executive Pay' (1992) 68 Ind LJ 59, 69-70.
[71] See *Staff at Barclays Vote to Strike* (1995) *Financial Times* 5th May and *Pickets Tell How Disparity Drove Them on to the Street* (1995) *Times* 31st May.

popular ways of linking a director's pay to his performance is via the use of share options. Share options are popular with companies because they are seen as a means by which payment can be tied to performance. They are also popular with directors because they offer a risk-free opportunity to make a large profit. Share option schemes offer the director a chance to buy a number of shares in his company, usually at, or at a slight discount to, the current market price (known as the 'exercise' or 'strike' price), at some point in the future. Once this point in time has arrived, the director has several options. If the share price has dropped, then the director simply lets the options lapse with no personal loss. If, however, the share price has risen, then the director will most probably exercise the option, buy the shares, and then sell them off immediately for an instant profit. This profit can often dwarf the director's salary. For example, in 2008, Larry J Ellison, CEO of US company Oracle, received a salary of around $1 million (around £615,812). However, in the same year, he sold off his vested share options, thereby netting himself an additional $182 million (around £112 million).

Another remuneration component that has become more prominent amongst large companies is known as a 'golden handshake.' A golden handshake usually refers to a term in a director's service contract that provides that the director will receive some form of payment in the event of him leaving the company (this may include being fired or even if he retires). Golden handshakes are increasing in both size and number. For many years, the largest golden handshake received by a director was the $53.8 million (around £33.2 million) received by F Ross Johnson, when his company, RJR Nabisco, was take over in 1989. However, in December 2006, Harry McKinnel, the retiring CEO of Pfizer Inc received a retirement package totalling $181 million (around £111.8 million).

A more worrying trend is the payment of golden handshakes to directors departing due to poor performance. In 1993, due to a series of poor financial reports British Aerospace sacked 21,000 employees. The CEO, John Cahill, thought this a 'matter of considerable regret'[72] and promptly resigned. However, despite his failure, he still received a golden handshake of £3.1 million. Similarly, Phillip Green received £1,132,000 when he left department store group Amber Day in the same year that the company announced a loss of £7 million. In America, departing directors have been able to negotiate even more incredible retirement plans. In 2000, Coca-Cola's CEO Douglas Ivester announced his retirement. During his two-year tenure as CEO, the company produced a negative return to shareholders of 7.3%, and yet he walked away with a golden handshake of $120 million (around £74.2 million). He was also able to negotiate a separation agreement that included annual payments of $1.5 million (around £928,000), additional monthly payments of $66,300 (around £41,000), medical benefits for himself and his wife, office space and secretarial services, maintenance of his home security systems and club dues for his existing club memberships. He also received title to his company car, mobile phones, and computers.

Finally, we are starting to see the appearance of 'golden hellos.' These are payments given to directors merely for agreeing to join a company and, as such, are not in any way tied to performance. In March 2009, Credit Suisse, a Swiss investment bank, revealed that it had paid 42.5 million Swiss Francs (around £24.2 million) in golden hellos at a time when it was cutting 11,000 jobs, with the highest single payment amounting to 19 million Swiss Francs (around £10.8 million).

It is now universally acknowledged that board remuneration, and the mechanisms that regulate it, are one of the most important incentive mechanisms that shape and direct director

[72] Quoted in Labour Research Department, 'More Than A Fond Farewell?' (1994) 83(9) Labour Research 23, 23.

behaviour.[73] Accordingly, an effective mechanism for regulating board remuneration will benefit society by guiding directorial efforts towards legitimate economic and societal goals. To date, perhaps the most important of these mechanisms has been the remuneration committee.

Determination of remuneration

The determination of directors' remuneration is a matter for the company's articles, and, if the articles are silent on this, the company in general meeting can authorize remuneration.[74] Historically, the articles normally stated that remuneration was to be decided by the company in general meeting.[75] The current model articles differ and provide that the directors are 'entitled to such remuneration as the directors determine – (a) for their services to the company as directors, and (b) for any other service which they undertake to the company.'[76]

There is a clear conflict of interest in allowing directors to set their own pay, and a real danger that directors will pay themselves more than they deserve, or will award themselves more than the market rate. Indeed, the last two decades are replete with examples of directors who have received handsome remuneration packages, despite weak performance.

To combat this, the UK Corporate Governance Code states that '[n]o director should be involved in deciding his or her own remuneration.'[77] To that end, the board should establish a remuneration committee of at least three independent non-executive directors,[78] which will then have delegated authority from the board to determine the remuneration of the executive directors. The terms of reference upon which the committee is appointed and the authority delegated to it should be made available.[79] The effectiveness of the remuneration committee is discussed in more detail in the Online Chapter entitled 'Directors' Remuneration', but it is worth noting here that the effectiveness of remuneration committees has been doubted as directors are still being paid significant sums even where the company sustains heavy losses due to poor performance or unlawful conduct.

Disclosure

As noted, the law does not seek to regulate the determination of directors' pay, preferring to leave that to the companies themselves via the articles. The law's stance appears to be that it is up to the members through the general meeting to decide if they agree with the company's remuneration policy. However, the members can only do this if they are fully informed of the company's remuneration policy and have access to the details of each director's pay. To that end, companies are required to disclose certain information regarding directors' remuneration, with three tiers of obligations being in operation.

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[73] See *e.g.* J Cordeiro, R Veliyath and EJ Erasmus, 'An Empirical Investigation of the Determinants of Outside Director Compensation' (2000) 8 Corporate Governance: An International Review 268; LR Gomez-Mejia and RM Wiseman, 'Reframing Executive Compensation: An Assessment and Outlook' (1997) 23 Journal of Management 291.

[74] In such a case, remuneration will be regarded as a gratuity (*Re George Newman & Co* [1895] 1 Ch 674 (CA)).

[75] Indeed, art 82 of Table A provided that '[t]he directors shall be entitled to such remuneration as the company may by ordinary resolution determine …'

[76] Model articles for private companies, art 19(2); model articles for public companies, art 23(2).

[77] Financial Reporting Council, The UK Corporate Governance Code (FRC 2016) Main Principle D.2.

[78] ibid Code Provision D.2.1. For companies below the FTSE 350, the Code recommends that the remuneration committee consist of at least two independent non-executive directors.

[79] ibid. This overlaps with r 7.2.7 of the Disclosure Rules and Transparency Rules, which provide that issuers of shares on a regulated market must provide details of the composition and operation of board committees in their corporate governance statement.

The first tier of obligations applies to all companies, but these are few in number (recognizing the fact that, in smaller companies, directors' remuneration is not normally a contentious issue). In fact, the only disclosure obligation in the CA 2006 that applies to all companies is the requirement to keep copies of the service contract of each director and shadow director,[80] which can be inspected by any member free of charge.[81] The copies must be kept available for inspection for at least one year following the expiration or termination of the contract.[82] Failure to comply with these rules constitutes a criminal offence by every officer in default.[83]

The second tier of obligations apply only to large and medium-sized companies and derive from the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008.[84] Schedule 5, para 1 provides that all large and medium-sized companies must disclose:

- the aggregate amount of remuneration paid to the directors;
- the aggregate amount of gains made by directors on the exercise of share options;
- the aggregate amount of money paid or assets received under a long-term incentive scheme, and
- the aggregate value of company contributions paid into directors' pensions schemes.

Unquoted large and medium-sized companies must disclose additional information, namely:

- details regarding the pay of its highest paid director;[85]
- details regarding retirement benefits paid to directors and past directors;[86]
- details regarding payments made to directors for loss of office,[87] and;
- details regarding sums paid to third parties in respect of directors' services.[88]

The third tier of obligations apply only to quoted companies, namely the requirement to prepare a remuneration report,[89] the policy section of which is subject to a binding vote which must take place at least every three years[90] (the non-policy section is subject to an annual vote, which is advisory only). Granting shareholders a 'say on pay' is a controversial topic, as shareholders of quoted companies were granted an advisory vote in 2002, but have used it rarely since. Time will tell whether the binding vote will prove more useful.

Institutional investors

Often, we will transfer money to others so that they can look after it for us, or return it to us should certain contingencies occur. We open bank accounts and trust banks to look after our money. We pay money into pension funds, so that, upon retirement, we will have a regular source of income.

[80] CA 2006, ss 228(1) and 230. If the contract is not in writing, then a written memorandum setting out the terms must be kept.
[81] ibid s 229(1).
[82] ibid s 228(3).
[83] ibid s 228(5) and (6). Unlike under previous Companies Acts, the company itself is not liable.
[84] SI 2008/410. These regulations were created under s 412 of the CA 2006, which allows the Secretary of State to pass regulations stating what remuneration information must be disclosed in the company's annual accounts.
[85] Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008, Sch 5, para 2. This information is not required if the amount is less than £200,000.
[86] ibid Sch 5, para 3.
[87] ibid Sch 5, para 4.
[88] ibid Sch 5, para 5.
[89] CA 2006, s 420.
[90] ibid ss 439 and 439A.

We pay insurance premiums to insurance companies so that, if certain unfortunate events occur, we will be compensated for any loss suffered. When we transfer our money to banks, insurance companies, or pension funds holders, they use the money we give them to make a profit for themselves, and one of the most popular ways they use this money is to invest in the share market. And because they usually have access to much greater funds that individuals like you or I, they can invest much more heavily in the share market. The increasing share ownership of pension funds, insurance companies, unit trusts, and banks (or institutional investors as they have come to be known) has transformed the UK corporate governance landscape.

In 1963, 54% of UK shares were in the hands of individual shareholders, with approximately 29% of shares in the hands of institutional investors.[91] The following table demonstrates how radically UK share ownership has been transformed since 1963.

Share Ownership, 1963 and 2014

Identity of investor	% of shares held in 1963	% of shares held in 2014
Insurance companies	10	5.9
Pension funds	6.4	3.0
Unit trusts	1.3	9.0
Banks	1.3	1.4
Overseas[92]	7	53.8
Individuals	54	11.9

The trend is obvious. Ownership by individuals has decreased rapidly, whilst ownership by institutions (especially overseas institutions) has increased rapidly. The Myners Report (discussed above) stated that over £1.5 trillion of shares lie in the hands of institutional investors.[93] The obvious question to ask is what is the practical significance of this change in share ownership. In 1932, Berle and Means[94] famously explained their thesis on the separation of ownership and control, in which they stated that those who controlled companies (namely, the directors) had escaped effective control of the owners of companies (namely, the shareholders) and, as a result, corporate accountability had decreased. The separation of ownership and control has doubtless resulted in a practical lessening of shareholder power, as evidenced by the failure of the AGM to be a true forum for shareholder democracy. This eclipse of the private individual by the institution investor challenges the traditional model of the corporation based on the separation of ownership and control. This concentration of assets creates potential for intervention in the corporate governance matters of portfolio companies.[95] This in turn may re-ignite the shareholders' ability to effectively participate in the governance of the company. The classic separation of ownership and control may therefore be halted or even reversed.

The UK appears well suited for institutional intervention. Ownership concentration is high, albeit not as high as many believe. The institutional environment in the UK is close-knit in that most institutional investors are based within a small area in the City of London. Institutional

[91] Office for National Statistics, 'Share Ownership: A Report on Ownership of UK Shares as at 31st December 2006' (HMSO 2007) 9, Table A.
[92] The majority of overseas investors tend to be overseas institutions, notably US institutions.
[93] Paul Myners, 'Institutional Investment in the United Kingdom: A Review' (HM Treasury 2001) [4].
[94] AA Berle and GC Means, *The Modern Corporation and Private Property* (Harcourt Brace 1932).
[95] This potential has been recognised for some time; see AA Berle, *Power Without Property: A New Development in American Political Economy* (Sidgwick & Jackson 1960) 53.

shareholders can communicate quite easily, both through formal committees and through more informal professional contact. For example, companies' views on corporate governance tend to be channelled through the investment committees of their trade associations, such as the Association of British Insurers (ABI) or the National Association of Pension Funds (NAPF). This type of formal and informal contact creates the potential for monitoring on a more cost-efficient basis than could ever be achieved by individual shareholders acting independently. Finally, the legal environment is conducive to institutional ownership as communication between institutions is largely unregulated. Given this, commentators had high hopes for the ability of institutional investors to exercise more control and improve standards of corporate governance, with one commentator stating that 'the holdings of these institutions are now so large that a manageable number of funds could feasibly join hands to supervise managers in a new system of control.'[96] This new system of control never arrived, and the question to ask is why did institutional investors never have the impact upon the promotion of good corporate governance that many believed they would have.

The effectiveness of institutional investors

Before we discuss why institutional investors have not been as effective as many hoped, it is worth noting that the level of institutional investor activism may be higher than is apparent because institutional investors tend to engage in 'behind-the-scenes' negotiation. The reason for this is that, if a large institutional investor were to publicly display dissatisfaction with the way that a company is run, other members could panic which could trigger a 'race to exit'. Certainly experience has demonstrated that, in many cases, if a dispute between the company and its institutional investor becomes public, then everyone ultimately loses as the company's share price usually slumps. However, even taking into account the institutions' reputation for behind-the-scenes activism, there is still a widespread belief that institutional investors have not yet had the impact that many believed they would. The question is why.

Although over half of UK shares are in the hands of institutional investors, a single institutional investor will, in order to diversify their risk, typically not hold more than 5 per cent of shares in a single company. Accordingly, a single institutional investor will normally need to try and form a coalition with other investors. However, forming and maintaining a coalition of institutional investors can be a difficult task for several reasons:

- Shareholder activism involves expense in terms of time, effort, and cost. As the benefits of shareholder activism usually go to all the members (not just the active ones), it follows that passive members have no real incentive to expend resources in aiding the active members. This is known as the 'free rider' problem as the passive members can free-ride off the active members' efforts. This reduces the members' incentive to voluntarily co-operate, thereby making it harder to form a coalition of the necessary size.
- Institutional investors can only carry out their functions effectively if they have adequate information on the companies in which they hold shares. Acquiring such information can be costly. For smaller members, the costs of acquiring such information will usually outweigh the benefits. Larger members, such as institutional investors, may be able to bear the cost of acquiring information, but they will also need to disseminate that information to the other members. The combined costs of acquiring and disseminating the information may outweigh the benefits that would be gained should their efforts succeed.

However, despite the fact that institutional investors' activism has not resulted in a new era of accountability and shareholder control, they have still undoubtedly had an impact upon the UK's

[96] AF Conrad, *Beyond Managerialism: Investor Capitalism?* (1988) 22 U Mich J L Ref 117, 119.

corporate governance system. In recent years, it has become clear that institutional investors have started to take their governance role more seriously, especially in relation to using the voting power of their shares. The **guidance to Principle 6 of the UK Stewardship Code** states that '[i]nstitutional investors should seek to vote all shares held' and the **guidance to Principle 3** states that they should 'attend the General Meetings of companies in which they have a major holding, where appropriate and practicable'. Today, most large institutional investors have a policy of attending AGMs and attempting to vote on all issues discussed at the AGM. However, voting levels, whilst steadily increasing, could be higher. The Myners Report stated that voting levels in 1999 stood at 50 per cent, compared to just 20 per cent in 1990. More recent research has institutional voting levels at around 60–65 per cent.

As stated earlier, UK institutional investors have a reputation for behind-the-scenes activism. However, in recent years, it would appear that the institutions have become more bold and, in certain governance areas (especially directors' remuneration), the institutions have been willing to engage in public and often bitter disputes with management and they have demonstrated that, when motivated, they can indeed improve standards of corporate governance.

However, there is still much scope for improvement. There are many who have argued that the recent financial crisis was caused, in part, by the failure of institutional investors to effectively monitor banks in which they held shares. The 2009 Walker Review backed this up to an extent by stating that institutional investors were 'slow to act' when concerns arose. Accordingly, the Review recommended that a code be created that would encourage institutional investors to better engage with their role as stewards of the company.

The UK Stewardship Code

As discussed, in an effort to encourage investors to engage more with their investee companies, the FRC published, in July 2010, the UK Stewardship Code.[97] The Code itself consists of seven broad principles, namely that institutional investors should:

1. publicly disclose their policy on how they will discharge their stewardship responsibilities;
2. have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed;
3. monitor their investee companies;
4. establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value;
5. be willing to act collectively with other investors where appropriate;
6. have a clear policy on voting and disclosure of voting activity;
7. report periodically on their stewardship and voting activities.

In Code was updated again in 2012, but the above principles remained largely intact.

Non-executive directors (NEDs)

Over the last 20-30 years, the UK corporate governance system has come to place great emphasis on the importance of non-executive directors (NEDs), with one report branding them as the 'custodians of the governance process.'[98] Indeed, the UK Corporate Governance Code places such importance on their role that it recommends that, in FTSE 350 companies, at least

[97] FRC, *The UK Stewardship Code* (FRC 2010).
[98] Derek Higgs, 'Review of the Role and Effectiveness of Non-Executive Directors' (DTI 2003) [1.6].

half the board (excluding the chairman) should consist of independent NEDs.[99] Grant Thornton's annual Corporate Governance Review[100] reveals that 88.5% of FTSE 350 companies comply with this recommendation.

Despite their importance, NEDs are not recognised by statute as a distinct type of director, although the courts, in applying and interpreting the Act, can recognise the distinction (for example, when determining the standard of care under s 174). The CA 2006 never uses the term 'non-executive director' and s 250 does not distinguish between executive directors and NEDs, although it is clear that the s 250 formulation covers both types of director.[101] Despite this, it is clear that, in practice, there is a significant distinction between executives and NEDs, as the following table indicates.

	Executive Directors	**Non-Executive Directors**
Role	Engage in the day-to-day management of the company	Involved in management, but should also monitor the executives
Employment Status	Usually appointed under a contract of service, so will be employees	Usually appointed via a letter of appointment and are therefore not employees
Full-time or part-time	Usually full-time	Part-time (usually around 1-2 days per month)
Remuneration	NEDs are paid much less than executive directors. FTSE 100 directors earn, on average, around £2.4 million per year.[102] FTSE 100 NEDs are paid, on average, £65,000 per year[103]	

The principal distinction between the executive directors and NEDs is in relation to their role. Whereas the executives' principal role is the day-to-day management of the company, the NEDs have two roles, namely management and monitoring.

The governance role of NEDs

Main Principle A.4 of the UK Corporate Governance Code provides that '[a]s part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy', thereby making clear that NEDs are expected to contribute towards the management and leadership of the company. The second role is found in A.4's Supporting Principle, which states that NEDs 'should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance', thereby making it clear that NEDs should also monitor the activities of the executive directors. However, it has been argued that the two roles do not sit easily with one another for several reasons. First,

[99] FRC, 'The UK Corporate Governance Code' (FRC 2016) [B.1.2]. For smaller companies, the Code recommends that the board have at least two independent NEDs.
[100] Grant Thornton, 'Corporate Governance Review 2015: Trust and Integrity–Loud and Clear' (Grant Thornton 2015) 29.
[101] Paragraph 278 of the Explanatory Notes to the CA 2006 states that the term 'director' includes a NED.
[102] Income Data Services, 'FTSE 100 Directors' Total Earnings Jump by 21% in a Year' available from <http://www.incomesdata.co.uk/wp-content/uploads/2014/10/IDS-FTSE-100-directors-pay-20141.pdf> accessed 28th April 2015.
[103] PriceWaterhouseCoopers, 'Non-Executive Director Fees: 2014 Review' (PWC 2015) 11.

it is unclear which role, if either, is to be afforded prominence. The Hampel Report stated that the focus on NEDs has resulted in the 'unintended side effect' of overemphasising their monitoring role.[104] Indeed, the Cadbury Report was conscious of this concern, stating that the Report's focus on the monitoring role 'should not in any way detract from the primary and positive contribution which they are expected to make, as equal board members, to the leadership of the company.'[105] Second, it has been argued that the monitoring function of the NEDs will segregate them from the executives and serves to force an implicit two-tier board philosophy onto a unitary board structure.[106] Opinion is divided on whether the tension between the two roles adversely affects the effectiveness of NEDs with some commentators of the opinion that the two roles cannot sit alongside one another,[107] with others indicating that likely conflicts are not as significant as believed.[108]

Perhaps the most significant concerns relating to NEDs relate to their independence. NEDs cannot effectively monitor their executive counterparts, nor can they bring a neutral, third party perspective to management, if they are not independent of the executives. The Higgs Report recommended that the Combined Code define what is meant by 'independence' and provided guidance which has since been incorporated within the UK Corporate Governance Code. Code Provision B.1.1 provides that the board should state in the company's annual report each NED that it considers independent, and that it should 'determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement.' Relationships or circumstances that could affect a director's independence include:

- the director has been an employee of the company within the last five years;
- the director has, or has had within the last three years, a material business relationship with the company;
- the director has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- the director has close family ties with any of the company's advisers, directors or senior employees;
- the director holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- the director represents a significant shareholder; or
- the director has served on the board for more than nine years from the date of their first election.

It should be noted that the existence of one of these relationships stated in Principle B.1.1 will not prevent a company from identifying a director as independent – the company will simply have to explain why it considers that director independent notwithstanding the relationship in question.[109] In 2015, 51 FTSE 350 companies stated their board consisted of NEDs considered to

[104] The Committee on Corporate Governance, 'Final Report' (Gee 1998) [3.7].
[105] 'Report of the Committee on the Financial Aspects of Corporate Governance' (Gee 1992) [4.10].
[106] Sir Owen Green, 'Why Cadbury Leaves a Bitter Taste' *Financial Times* (London, 9 June 1992).
[107] Mahmoud Ezzamel and Robert Watson, 'Wearing Two Hats: The Conflicting Control and Management Roles of Non-Executive Directors' in Kevin Keasey, Steve Thompson and Mark Wright (eds), *Corporate Governance: Economic, Management and Financial Issues* (OUP 1997).
[108] Laura F Spira and Ruth Bender, 'Compare and Contrast: Perspectives on Board Committees' (2004) 12 CG 489, 498.
[109] FRC, 'The UK Corporate Governance Code' (FRC 2016) Code Provision B.1.1.

be independent, despite those NEDs not complying with B.1.1.[110] Unfortunately, the explanations given were not robust – whilst 88% of FTSE 350 companies gave some insight as to why these NEDs were considered independent, only four companies recognised non-compliance in their compliance statement.[111] This indicates that there may be NEDs that are not genuinely independent, but are identified as such by their companies despite potential conflicts of interest.

However, even where such relationships do not exist, there still exists general concern over the independence of many NEDs. Many NEDs are often executive directors of other companies, a position which produces a heavy workload: indeed it has been suggested that persons who have not experienced the responsibilities of executive directorship would be unsuitable for positions as non-executive directors.[112] This means that they will have minimal time to monitor effectively the companies in question. A typical NED will spend between one or two days a month on company business and this will be spent in the boardroom, leaving little time to become conversant with the company's business. NEDs therefore rely on the executives to draw their attention to what is important, and the executives may be tempted to carefully select which information they pass onto the NEDs. Further, given that executive directors and NEDs are drawn from similar backgrounds, they may socialise with, or serve on other boards as fellow non-executives, with the executives they are supposed to monitor. Accordingly, it has been noted 'most outside directors share management's ideological disposition toward the single issue most central to their monitoring responsibilities: how intensely outside directors should monitor management.'[113] There is also the possibility that non-executives may 'pull their punches … out of an innate fear of encouraging non-execs on their own boards to rock the boat too often.'[114]

The appointment of NEDs is also a cause for concern. In virtually all UK listed companies, the appointment of all NEDs must be confirmed by an ordinary resolution at the general meeting following their appointment, and they are then subject to periodic re-election by the members. Historically, however, most NEDs of UK companies were selected by the chairman of the board, in many cases because the potential NEDs have a personal acquaintance with the chairman, with 'the shareholders providing only the official rubber stamp.'[115] In 1994, it was stated that 50% of non-executives in UK industrial companies were chosen by the chairman.[116] The difficulties posed by managers selecting their own monitors have diminished in recent years due to the prevalence of nomination committees, but doubts have been expressed at the effectiveness of nomination committees.

CHAPTER CONCLUSION

In chapters 18 to 24, we discussed the legal regulation of companies. But legal regulation has its limitations and, in the ever-evolving business world, the pace of change often outstrips the law's ability to keep up. It is therefore unsurprising that the UK corporate governance system has adopted a regulatory regime that can respond quickly and efficiently, namely by relying heavily

[110] Grant Thornton, 'Corporate Governance Review 2015: Trust and Integrity–Loud and Clear' (Grant Thornton 2015) 29.
[111] ibid.
[112] Ian Stratton, 'Non-Executive Directors: Are They Superfluous?' (1996) 17 Co Law 162, 164.
[113] Ronald J Gilson & Reinier Kraakman, 'Reinventing the Outside Director: An Agenda for Institutional Investors' (1991) 43 Stan L Rev 863, 875.
[114] See 'Knives are Out in the Boardroom' *Financial Times* (London, 1 May 1992) 11.
[115] Lilian Miles and Giles Proctor, 'Re-Designing the Office of Non-Executive Director: Has the Consultation Document Gone Far Enough?' (2000) 21 BLR 143, 144.
[116] KPMG, 'Survey of Non-Executive Directors' (KPMG 1994) 12.

on non-legal codes and reports. As we have seen, there can be little doubt that the use of such codes and reports offer considerable benefits compared to regulation by the law. The corporate governance mechanisms that we discussed in this chapter have undergone considerable change and the UK corporate governance system has been able to respond quickly to these changes, largely due to regular revisions of the Combined Code and, as it later became known as, the UK Corporate Governance Code. It is highly unlikely that statutory regulation could have matched the pace of change.

The important point to note is that good corporate governance is not simply about complying with legal requirements – good corporate governance requires compliance with a significant body of non-legal principles too. Good corporate governance is as concerned with efficiency as it is with accountability and transparency, so it is in the interests of companies to be good corporate citizens and aim to improve standards of corporate stewardship.

SELF-TEST QUESTIONS

1. Define the following:
    - remuneration committee
    - share options
    - golden handshake
    - institutional investors
    - non-executive directors

2. Do you think that the reliance on corporate governance reports and codes is a better way of promoting good corporate governance than statutory regulation?

3. Why do you think institutional investors have failed to improve standards of corporate governance in the way that many believed they would?

4. 'Non-executive directors can only fulfil their monitoring function if they are complete independent of the executives. Unfortunately, many non-executives cannot be described as truly independent.' Discuss.

FURTHER READING

- Christine A Mallin, *Corporate Governance* (5th edn, OUP 2016) chs 3, 6, 8 and 9 – Provides a clear and accessible account of many of the corporate governance issues discussed in this online chapter.
- Jill Solomon, *Corporate Governance and Accountability* (4th edn, Wiley 2013) chs 3, 4 and 5 – Discusses the use of corporate governance codes, NEDs, institutional investors and executive remuneration.
- K Keasey, S Thompson and M Wright (eds), *Corporate Governance: Accountability, Enterprise and International Comparisons* (Wiley, 2005) chs 2, 4, 5, 6 and 8 – A collection of essays on key corporate governance topics, including many of those discussed in this chapter.
- Lee Roach, 'The UK Stewardship Code' (2011) JCLS 463 – Discusses the origins and effectiveness of the UK Stewardship Code.

Websites

- http://www.frc.org.uk - The website of the Financial Reporting Council, the body that is responsible for reviewing and updating the UK Corporate Governance Code and the UK Stewardship Code.