

The Business Case for Corporate Governance

Edited by Ken Rushton

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The Business Case for Corporate Governance

This book goes beyond the ‘what and how’ of corporate governance to explore the impact and benefits of good governance for companies and their investors. The contributors are leading market practitioners, investors, academics and consultants who offer their own views based on a wealth of experience. Topics covered include what makes for an effective board and is the unitary board sustainable? The contribution of governance to financial performance – is the research conclusive? Managing risk and reputation – how do boards ensure they are trusted by their shareholders? The benefits of market-led standard setting – do US and EU regulatory initiatives threaten the traditional UK approach? The book looks to dispel the belief that governance is a burden on companies that adds little value by demonstrating the contribution it makes to board effectiveness and corporate performance.

KEN RUSHTON is a former Director of Listing, Financial Services Authority and Company Secretary ICI.

Contributors

Will Chalk
Addleshaw Goddard

Hans-Christoph Hirt
Hermes Investment Management

David Jackson
BP plc

Keith Johnstone
Addleshaw Goddard

Simon Lowe
Grant Thornton

Charles Mayo
Simmons & Simmons

Colin Melvin
Hermes Investment Management

Peter Montagnon
Association of British Insurers

Stilpon Nestor
Nestor Advisors

Sir Bryan Nicholson
*Formerly Financial Reporting
Council*

Sir Geoffrey Owen
London School of Economics

Ken Rushton
*Formerly Imperial Chemical
Industries PLC*

Murray Steele
Cranfield School of Management

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Introduction

KEN RUSHTON

This book is not intended to be another handbook or primer on corporate governance. Although readers will find chapters, such as those by Charles Mayo and Stilpon Nestor, that describe recent developments in laws and regulations, the main purpose of the book is to describe corporate governance in practice from the viewpoints of the principal players, including the board of directors, the regulator and the investor. Contributors have focused on the benefits of good governance and a number have written about events and their own experiences that demonstrate governance in action: both positive and negative examples.

I hope that the book will appeal not only to lawyers but also to those working in listed companies. Those who are directors may identify with the views of Sir Geoffrey Owen and many of the Chairmen I interviewed who believe that boards are becoming more professional. The role of director, whether executive or non-executive, can no longer be considered simply as a promotion for a successful senior manager or a reward for doing a good job running another business. Being a director is a job in its own right that demands specific skills and individual qualities. Aspiring directors will gain an appreciation of the value of good governance for their business and should understand the importance of high-performance effective boards for corporate success. Colin Melvin and Hans-Christoph Hirt from Hermes Investment Management have written about the academic and professional studies that show that good governance leads to improved corporate performance.

Similarly, I hope institutional investors who read this book will understand the benefits of responsible activism. Peter Montagnon writes that the relationship between companies and their investors on governance should not be confrontational, but that the quality of the dialogue must be improved. As Melvin and Hirt contend, positive engagement with investors results in more value-creation for companies.

UK regulators, supported by Government, take the view that the public interest is best served by market-based solutions to governance issues rather than by regulation. Sir Bryan Nicholson points out that voluntary codes, reinforced by the Listing Rules, are more flexible and more aspirational than laws and regulation. Laws require compliance with minimum standards while codes focus on raising standards. Sir Bryan, and other contributors, compare the UK principles-based approach favourably with the US rules-based approach and

criticise the knee-jerk reaction of US legislators following Enron, World Com *et al.* Although it is easy to criticise the Sarbanes-Oxley Act, it has helped to restore investor confidence in the US. Furthermore, it is arguable, as the chapter by Keith Johnstone and Will Chalk suggests, that corporate scandals on the scale of Enron in the UK would place enormous pressure on government to pursue a legislative response rather than continuing to rely on a voluntary code enforced by the market. The Government was sensible, following Enron, to call in regulators and market professionals to review what steps should be taken to reduce the risks of a similar scandal occurring in the UK. This review resulted in worthwhile measures for improving the effectiveness of oversight of audit and accounting.

What is corporate governance?

The classic definition was provided by Sir Adrian Cadbury in 1992: 'Corporate governance is the system by which companies are directed and controlled.' Although this definition focuses usefully on the board of directors, it is a somewhat narrow and mechanistic view of governance. Ira Millstein, the US lawyer whose views on corporate governance command international respect, defined corporate governance in 2003 as:

that blend of law, regulation and . . . voluntary private sector practices which enables the corporation to attract financial and human capital, perform efficiently . . . generating long-term economic value for its shareholders while respecting the interests of stakeholders and society as a whole.

Millstein recognises that good governance requires both regulation and voluntary measures, and he draws attention to the benefits for companies of good governance practices. This was also reflected in the 1998 Hampel Review in the UK which emphasised the importance of corporate governance for its contribution to business prosperity as well as to accountability. Millstein's work has influenced the OECD and when they published their revised Principles of Corporate Governance in 2004 they defined corporate governance as follows:

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.

In this last sentence, we find the link between governance and performance clearly expressed. It is this positive aspirational definition that is more likely to capture the enthusiasm of directors and managers as opposed to a definition calling for structures and processes that appear to be designed solely to police bad behaviour by boards of directors.

Sir Adrian Cadbury himself moved somewhat in this direction when he redefined corporate governance in 2003:

In its broadest sense, corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources.

Corporate responsibility and ethics

Sir Adrian Cadbury refers to ‘holding the balance between economic and social goals’ while Millstein mentions ‘respecting the interest of stakeholders and society as a whole’. Although the Company Law Review rejected the stakeholder model for a company when considering directors’ duties in favour of the ‘enlightened shareholder value’ model, as discussed by Charles Mayo, it is notable that the formulation of the legal duty to promote the success of the organisation in effect requires directors to ‘hold the balance between economic and social goals’. The enhanced Business Review, also discussed by Mayo and others, then requires directors to report annually on how they have fulfilled their responsibilities towards stakeholders.

When the OECD Principles referred to corporate governance involving a set of relationships between management, the directors, shareholders and other stakeholders, they articulated four basic principles to govern those relationships:

- accountability – to shareholders
- responsibility – to stakeholders
- transparency – in all actions
- fairness – in treatment of shareholders.

Follow these principles, the argument goes, and companies will be rewarded by a lower cost of capital as they will be seen to be less risky. Their performance will benefit from better information flows and more rigorous decision-making. Investors will have more confidence in companies that respect their rights and produce fewer bad surprises. In essence, the proposition is that well-governed companies offer investors better returns on their investments. In addition, good governance produces superior operational performance through more considered allocation of resources creating more wealth.

I am delighted that a number of contributors (including Owen, Montagnon, Johnstone and Chalk, and Melvin and Hirt) have chosen to emphasise how corporate (social) responsibility is now a key component of corporate governance and reputation management. In conversations with business leaders about good governance, the word ‘integrity’ is often mentioned. I agree with Murray Steele when he picks out good judgement and integrity as essential qualities for directors. I have always thought of corporate governance and corporate

responsibility as sub-sets of business ethics. My interest in all these areas stems from my passion for business. From my days at university, I bought into the argument that business creates much of the wealth the country needs to provide public services and high living standards. I continue to be dismayed that business generally has a poor image and I have always felt that the media give business a raw deal.

Looking back, it seems that companies were slow to appreciate that competitive advantage could be gained by articulating strong values and insisting these values are lived up to and that high ethical standards are maintained by those working in the organisation, especially by those at the top of the organisation. Words like 'values' and 'ethics' were not often heard in boardrooms and might have been regarded as 'soft' issues only fit for Personnel or Communications departments to worry about.

Readers may not like the idea of linking values and ethical standards with competitive advantage. While I have never doubted that most business leaders have high integrity, I found in my short time at the Institute of Business Ethics that it was easier to command their attention if I used the language of business rather than the language of academic ethics which is rooted in philosophy.

Increasingly, talented people who can choose for whom they want to work, and thoughtful consumers who elect to choose from whom they will purchase goods and services, are adopting ethical criteria to inform their decisions. We are also seeing some institutional investors taking ethical considerations into their investment decisions. So companies should seek to gain a reputation for ethical and responsible behaviour because they appreciate it makes good business sense. Companies need to appreciate, however, that this is a high-risk area, as fine words and glossy communications, though helpful, are not sufficient if the leadership ignores reputation risks when making business decisions, or if those at the top of the organisation put self-interest ahead of the interests of shareholders and other stakeholders. The old adage 'actions speak louder than words' is never more true than when it comes to defending corporate reputation. To my mind, the disciplines of corporate governance, as captured in this book, should help a business leadership that is committed to ethical behaviour and reputation risk management.

Role of the board

Although corporate governance is sometimes criticised for being obsessed with structures and processes while it is understood that people and their behaviour are usually the cause of scandals, if those structures and processes are effective they can go a long way to ensuring that employees do act in the best interests of the company and comply with corporate policies.

I appreciate this is making corporate governance appear to be no more than a monitoring tool, and those responsible for the stewardship of corporate governance are often referred to as watchdogs or corporate policemen. A number

of the contributors to this book discuss whether the role of the board is to monitor compliance with the law and recognised standards, such as the Combined Code, or whether it is rather to raise the performance of the business while supervising management. The answer, surely, must be that the board is responsible for both. I agree, however, that boards who perceive corporate governance merely as another compliance obligation are missing the point that good governance is good business. David Jackson, as a Company Secretary, sees his role as assisting his Chairman and the non-executive directors to use the corporate governance framework as a means of getting more effective performance and more value from the board. Jackson points out with delight that the focus on corporate governance has promoted the Company Secretary from being a mere servant of the board to being chief of the Chairman's staff.

As the authors have shown, board evaluation has become commonplace since Sir Derek Higgs reported. It would be valuable, as Sir Geoffrey Owen suggests, if there was a better way of measuring the performance and contribution of the board. The German Society of Investment Analysis and Asset Management in 2000 developed a corporate governance scorecard based mainly on the German corporate governance code. Although the scorecard was intended to be used mainly by investors, it can also be used by boards to evaluate the quality of their own governance frameworks. It would be interesting to see if such scorecards could be developed for UK companies to use as part of their board evaluation process.

Is corporate governance working?

The evidence from the reviews of the Combined Code carried out in recent years by the Financial Reporting Council is encouraging. Many countries use the UK as their model for developing corporate governance regimes, as the US is no longer seen as the gold standard. The absence of a developed institutional shareholder base may mean that other countries look for tougher enforcement mechanisms. Simon Lowe points out in chapter 11 that only 10 per cent of the FTSE 350 companies comply in full with the Combined Code. However, the Code is promoted on the basis of comply-or-explain and is not intended to be applied as a one size fits all set of rules.

A greater concern has been that companies could be defaulting to compliance with the provisions of the Code rather than risk having to justify deviations to their investors or other critics. Companies criticise box-ticking by proxy voting agencies and others whom they accuse of having little interest in finding out the reasons why boards might choose not to implement certain Code provisions. However, some companies regrettably choose to adopt a box-ticking approach themselves when implementing the Code and when describing their corporate governance arrangements in their annual reports. Those that do choose to explain why they are not complying with a provision often use boilerplate,

me-too language rather than providing a customised explanation appropriate to the circumstances of the company.

I would like to see more companies use the corporate governance statement to investors to describe how they have applied the principles of the Combined Code. This is currently a Listing Rule requirement, and I suggest that if investors had a better understanding of a board's strategy for implementing corporate governance requirements, this would improve the quality of the dialogue between companies and their investors around departures from Code provisions. Peter Montagnon accepts that the quality of this dialogue is sometimes deficient and he lays the blame on the way both companies and investors tend to compartmentalise their communications. I agree there are situations which can be defused by earlier contacts between Chairmen or senior independent directors and Chief Investment Officers rather than leaving the corporate governance specialists to conduct the engagement for too long. As Montagnon recognises, there is still a weakness in that the governance and investment processes in institutions are insufficiently joined up. This results in board members often seeking to bypass the governance specialists. Also, in smaller companies it is often the case that governance is regarded mainly as a compliance activity to be managed by a senior official such as the Company Secretary rather than a board responsibility.

Contribution of non-executive directors

Another hallmark for governance is to assess the effectiveness of non-executive directors. This is not easy as one has to rely on anecdotal evidence. It is certainly true that boards are taking more trouble to appoint suitable non-executive directors. The nomination committee has assumed far more importance and the process for recruitment and appointment has become more sophisticated. It is remarkable that the pool of talented candidates for non-executive director appointments remains so deep given the risk-reward ratio and the time commitment to do the job properly. Murray Steele considers that many investors are slow to challenge companies with weak performance and rely instead on non-executive directors to provide challenge to the 'acceptable under-performance' mindsets of their executive colleagues. I recall one highly regarded US activist investor saying at a conference that there were certain eminent non-executive directors in the UK whom he felt confident would do a good job in looking after shareholder interests, and if he saw their names on a board he was more relaxed.

My own experience confirms that a conscientious non-executive director can really make a valuable contribution both to fulfilling the board's monitoring responsibilities and to the quality of its decision-making. Much will depend on his level of commitment to understanding the business and his willingness to ask the awkward questions, as well as on his individual skills and experience. It worries me, however, that commentators and some investors

have unrealistic expectations of what non-executive directors can achieve, following the Higgs review. Their limitations were dramatically exposed in the Equitable Life and Northern Rock collapses, which demonstrated that it remains true that it is the Chief Executive and his management who run the business.

I am also concerned that a number of UK boards are moving towards the US model of having a minority of executive directors and appointing more non-executive directors. Although I welcome the trend for smaller boards, I have always believed that a balanced board comprising roughly equal numbers of executive and non-executive directors is desirable. The Chief Executive should be supported by a few executives who share responsibility for board decisions. This serves as a useful check on the powers of the Chief Executive who might otherwise be tempted to be selective in the information he shares with the board, and also gives the board a close-up view of potential successors to the Chief Executive. Choosing the Chief Executive is, arguably, the most important decision a board will make; firing a failed Chief Executive runs it a close second.

Sanctions

The topic of sanctions is well covered by Keith Johnstone and Will Chalk who have introduced the interesting concept of the Virtuous Circle. It will be fascinating to see how the population in the Circle might change over time. One sanction which I consider to have been underdeveloped is the power to disqualify errant directors for serious breaches. I am pleased that Johnstone and Chalk appear to support my view. When I was Head of the UK Listing Authority, I failed to persuade the then DTI that such a power would be a helpful addition to our armoury. I am not convinced that the sanction of a fine, even though unlimited, is a sufficient deterrent for Chief Executives or Chief Financial Officers who are determined to mislead investors, possibly for their own personal gain. Such serious breaches of the Listing Rules demonstrate that the individual directors concerned lack integrity and are not fit for office. An alternative is to introduce a licensing system for directors of listed companies on the lines of the 'approved persons' regime for financial services organisations. I believe that the disqualification power is a preferable option. It is not easy to convince enforcement authorities that are not courts or tribunals to bring actions against individuals in breaches of Listing Rules cases. The hurdles are set high and I believe the alternative of seeking a disqualification order from the Companies Court should be explored again. Given the choice, I believe the market would prefer to see proceedings brought against a reckless director rather than punishing the shareholders (possibly for a second time) by pursuing the company for a fine in respect of the behaviour of one or more of its directors.

The future of corporate governance

Stilpon Nestor describes regulatory trends in the US and the EU in his chapter. A number of influential commentators in the US are calling for principles-based regulation and comparing the approach of US regulators, such as the SEC and the New York Stock Exchange, unfavourably with our own. UK companies that remain listed in New York (and a number have delisted in recent years) face the costs and complexities of compliance with the Sarbanes-Oxley Act, though some of the burdens have been lifted for foreign registrants.

In the EU, the Company Law Action Plan at one time appeared to threaten our market-based approach to corporate governance. Our Government have so far done well in Brussels in influencing the implementation of the Action Plan so that, by and large, the UK approach to corporate governance has not been impaired. We have been helped by the philosophy of Commissioner McCreevy, a strong believer in better regulation, which means the need to demonstrate market failure that can only be remedied by regulation before going down the road of legislation. While his approach should be applauded, it remains to be seen whether it will be maintained when there is a change of Commissioner.

The EU Commission would like to see greater convergence of national corporate governance codes, though it no longer talks of an EU-wide code. Although convergence would be consistent with a single market, the differences in national laws and structures of companies and their ownership make such an outcome unlikely.

In the UK, it is generally agreed that we have a code that is fit for purpose. It is regularly reviewed and minor changes are made, often to suit the needs of smaller companies. The Financial Reporting Council is rightly focused on how well the Code is being implemented by companies and shareholders alike. There are concerns that the effectiveness of comply-or-explain would be damaged if both companies and shareholders lapsed into a box-ticking approach to compliance. Contributors to this book urge companies to provide more thoughtful corporate governance statements in their annual reports, particularly when they are explaining why they have departed from the Code's provisions. Similarly, investors need to be more active in their engagement activities with companies if the comply-or-explain approach is to be sustained. The benefits of responsible constructive activism are demonstrated by the success of focus funds, as described by Melvin and Hirt. As Montagnon relates, the UK Government supported the market-based approach rather than regulation of corporate governance because it saw shareholder power being more business friendly, but it still requires shareholders to use their powers sensibly. Melvin and Hirt provide an interesting case study in Premier Oil which shows how a thoughtful, long-term engagement between investors and the most senior board members helped to turn a company round. It is also a good example of how a company Chairman can influence his board by listening to his investors.

One direction which corporate governance could take is to lay down more rules regarding the responsibilities of institutional shareholders. I think it is unlikely that the Financial Reporting Council will wish to pursue this line. There is already some criticism that Section 2 of the Combined Code, which deals with institutional investors in terms of their voting responsibilities, the role of activism and the need for careful evaluation of company disclosures, sits uneasily in a Code that is aimed at the behaviour of companies. As implementation of the Code relies on policing by shareholders, when it comes to the responsibilities of shareholders themselves one has to ask ‘quis ipsos custodiet?’ (who guards the guards?). It is commendable that shareholder bodies such as the Institutional Shareholders Committee and the International Corporate Governance Network have published statements of shareholder responsibilities. It is perhaps now time for these bodies to consider how compliance with these policies should be monitored and whether sanctions are necessary for non-compliance.

Challenges

Sir Bryan Nicholson and Peter Montagnon highlight further challenges to corporate governance, including:

- The growing influence of hedge funds, many with short-term interests in ownership compared with institutional investors and therefore less interest in governance.
- The increase in ownership of UK companies by foreign investors who have different experiences and expectations of good governance.
- The possibility that institutional investors, when they see that their influence over boards is diminishing, will become apathetic about engagement, which might also result in companies taking even less care with their governance disclosures.
- Boards of directors may become confused about their role and the unitary board itself could be threatened. It may become more difficult to find strong Chairmen and effective non-executive directors who are willing to give the time to challenge underperformance and weak internal controls.
- Small companies may find the burden of corporate governance so great that they desert the main market and find refuge on AIM or other markets. But that begs the question of how long those markets can continue without raising their standards of corporate governance.