



Milestones in UK Corporate Governance

Cadbury Report (1992)

The Cadbury Report, formally entitled 'The Report of the Committee on the Financial Aspects of Corporate Governance' was published in December 1992, following the recommendations of the Cadbury Committee. The establishment of the Committee in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession arose in response to the occurrence of financial scandals in the 1980's involving UK listed Companies, which led to a fall in investor confidence in the quality of company's financial reporting.

As such the Committee **addressed the financial aspects of corporate governance** and subsequently produced a **Code of Best Practice**, the provisions of which, in their belief, all boards of UK listed companies should comply with. Specifically, they recommended that listed companies should incorporate a formal *statement* into their Report and Accounts *outlining whether or not they complied with each of the Code's provisions*. In respect of areas of non-compliance an *explanation* of the reason was sought. Further to this, the Report recommended that the compliance statements made by the companies be reviewed by auditors prior to release of the Annual Report.

The key focus of the provisions of the Code of Best Practice primarily related to the *composition of the Board of Director's*, the *appointment and independence of non-executive directors*, the *service contracts and remuneration of executive directors*, and *company's financial reporting and controls*.

Some of the **main recommendations** made are as follows:

- The majority of non-executive directors should be independent of management and free from any business or other relationship;
- non-executive directors should be appointed for specified terms;
- service contracts should not exceed three years;
- executive remuneration should be subject to the recommendations of a Remuneration Committee made up entirely or mainly of non-executive directors; and
- an Audit Committee, comprising of at least three non-executive's, should be established.

Following publication of the Code the *London Stock Exchange* introduced a requirement into the Listing Rules requesting all companies to include a statement of compliance, or non-compliance, with the provisions, in their annual Report and Accounts. Furthermore, institutional investors and Investment banks urged those listed companies for which they provided sponsorship and advice to adopt the provisions. As a result many companies changed their governance procedures and conduct accordingly.

Greenbury Report (1995)

During the 1990's the issue of **director's remuneration** was becoming a primary concern for investors and the public at large. Specifically, the levels of remuneration of directors in privatised

Milestones in UK Corporate Governance

industries were rising and remuneration packages were failing to provide the necessary incentives for directors to perform better.

Consequently, it was recognised that corporate governance issues relating to director's remuneration needed to be addressed in a more rigorous manner. This led to the establishment of the Greenbury Committee.

The Committee's findings were documented in the Greenbury Report, which incorporated a *Code of Best Practice on Director's Remuneration*.

Specifically, four main issues were dealt with, as follows:

- the *role of a Remuneration Committee* in setting the remuneration packages for the CEO and other directors;
- the *required level of disclosure* needed by shareholders regarding details of directors remuneration and whether there is the need to obtain shareholder approval;
- specific guidelines for determining a *remuneration policy* for directors; and
- *service contracts* and provisions binding the Company to pay compensation to a director, particularly in the event of dismissal for unsatisfactory performance.

As in the Cadbury Code, the Greenbury Code recommended the establishment of a Remuneration Committee, comprising entirely of non-executive directors, to determine the remuneration of the executive directors. However, in terms of service contracts, Greenbury recommended a *maximum notice period of 12 months* rather than three years as suggested by Cadbury.

Following publication, the recommendations of Greenbury were also taken on board by the *London Stock Exchange* and incorporated into the UK Listing Rules. However, unlike the Cadbury Code it was not widely accepted as many believed that the recommendations made did not sufficiently deal with the issue of linking directors pay to the Company's performance in the interests of shareholders.

Hampel Report (1998)

The Hampel Committee was established in 1996 to review and revise the earlier recommendations of the Cadbury and Greenbury Committees. The Final report **emphasised principles of good governance rather than explicit rules** in order to reduce the regulatory burden on companies and avoid 'box-ticking' so as to be flexible enough to be applicable to all companies. It was recognised that good corporate governance will largely depend on the particular situation of each company. This emphasis on principles would survive into the Combined Code.

Hampel viewed governance from a strict principal/agent perspective regarding corporate governance as an opportunity to enhance long term shareholder value, which was asserted as the primary objective of the company. This was a new development from the Cadbury and Greenbury Codes which had primarily focused on preventing the abuse of the discretionary authority entrusted to management. In particular, the report favoured greater shareholder involvement in company affairs. For example, while the report recommended that *unrelated proposals should not be bundled* under one resolution shareholders, particularly institutional shareholders, were expected to adopt a, 'considered policy' on voting.

Another key advance was in the area of *accountability and audit*. The Board was identified as having responsibility to maintain a sound system of internal control, thereby safeguarding shareholders' investments (although the Board was not required to report on the effectiveness of the controls). Further, the Board was to be held accountable for *all aspects of risk management*, as opposed to just the financial controls as recommended by Cadbury.

Hampel did not advance the debate on director's remuneration, choosing only to reiterate principles inherent in Greenbury. In particular Hampel did not believe that directors' remuneration should be a matter for shareholder approval in general meeting. This would not become a requirement until the introduction of The Directors' Remuneration Report Regulations in 2002.

Combined Code (1998)

The Combined Code **consolidated the principles and recommendations** of the Cadbury, Greenbury and Hampel reports. It was formulated in 1998 and revised in 2003 following the publication of the Higgs report.

The Code is divided into two sections. The first outlines principles of best practice and their supporting provisions for **companies**, while the second does the same for **shareholders**. While compliance with the Code is not mandatory, the Code was *appended to the listing rules* and listing rule 12:43A requires a statement by companies to provide shareholders with sufficient information to be able to assess the extent of compliance with section one of the Code. Instances of *non-compliance should be justified* to shareholders.

Section 1 of the Code is comprehensive covering topics such as the composition and operations of the Board, directors' remuneration, relationships with shareholders, the supply of information, and accountability and audit. The fact that the Code has provided **both principles and provisions** has resulted in a Code that is powerful enough to effect specific recommendations and flexible enough to be applicable to most companies.

Section 2 of the Code is much shorter, covering shareholder voting, dialogue with companies and the evaluation of governance disclosures. As institutional investors invest on behalf of the shareholders they represent they have a responsibility to hold the companies in which they invest to account. In particular, the Code recognised that the responsibility for maintaining good dialogue and mutual understanding belongs to both companies and its institutional investors. Finally when evaluating the quality of governance disclosure by companies, institutional investors are to give due weight to all relevant factors. This is rather vague and the area has been recognised as a shortcoming of the Code, leading to membership associations of institutional investors having to produce guidance to its members on this area.

Myners: Review of Institutional Investment (2001)

Paul Myners 'Institutional Investment in the UK: A Review' published in 2001, was commissioned by the Government, 'to consider whether there were factors distorting the investment decision-making of institutions.'

Within the Report's analysis, a number of problems with the current system are highlighted, in particular:

- There are wholly unrealistic demands being made of pension fund trustees, whereby they are being expected to make crucial investment decisions without either the resources or the expertise needed;
- consequently, there is too heavy a burden being placed on the investment consultants who advise the trustees to ensure the decisions made are correct;
- the job of asset allocation, the selection of which markets, as opposed to which individual stocks, to invest in, is under-resourced; and
- there is a lack of clarity about objectives at a number of levels, for instance the objectives of Fund managers, when taken together, appear to bear little relation to the ultimate objective of the pension fund.

Overall therefore, the Review concludes that the present structures used by the various types of institutional investors (for example pension funds and insurance companies) to make investment decisions lack both efficiency and flexibility, which often means that savers' money is not being invested in ways which will maximise their interests.

In response to the problematic issues raised, Myners has **outlined some basic principles of an effective approach to investment decision-making**, which if adopted by pension funds and other institutional investors would likely result in an all round more efficient system.

For example, he suggests Trustees should assess whether they have the right set of skills, both individually and collectively, and the right structures and processes to carry out their role

Milestones in UK Corporate Governance

effectively. They should draw up a forward-looking business plan. However, he stresses that making compliance to these provisions compulsory would not be the best approach; rather it would be more effective to take a similar stance to that of the Combined Code and preceding reports. Institutional investors would in that case either choose to adopt the recommendations of the Report, or if not publicly explain their reasons for not doing so.

Higgs Report (2003)

A report was published in 2003 following **Derek Higgs'** report into **the role of non-executive directors**. The report recommended a number of changes to the Combined Code and a **revision of the Code in July 2003** incorporated most of the Higgs recommendations.

The Report examined the role, independence and recruitment of non-executive directors. Higgs viewed the non-executive director's role as:

- making contributions to corporate strategy;
- monitoring the performance of executive management;
- satisfying themselves regarding the effectiveness of internal control;
- setting the remuneration of executive directors; and
- being involved in the nomination, removal and succession planning of senior management.

The Combined Code recommended that Boards should comprise of at least one-third non-executive directors, a majority of whom should be independent. However, the Code did not detail how to assess independence. Therefore Higgs outlined a series of tests of independence such as length of service (10 years), associations to executive management, financial interest or significant shareholding. In particular cross-directorships were identified as compromising independence, the simplest case being where two directors act as executive directors and non-executive directors alternatively at two companies. However, in practice there may be a complicated network of inter-relationships known as, 'an old boy's club' such that it remains difficult to externally determine a directors' independence.

With regard to recruitment, Higgs recommended stronger provisions governing nomination committees. Higgs called for all listed companies to establish a nomination committee, chaired by an independent NED (not the Chairman) and comprising a majority of independent non-executive directors. However, it was recognised that the recommendations regarding non-executive directors would be harder for smaller companies to adopt.

Other important recommendations of the Higgs report included:

- The Board should review its performance, the performance of its committees and individual directors at least once a year;
- The Company Secretary should be accountable to the Board through the Chairman on all governance matters; and
- The terms of reference of the remuneration committee should be published.

Revised Combined Code (2003)

The revised Combined Code, published in July 2003 was a direct result of the recommendations of the **Higgs** report outlined above and also the **Smith** review concerning Audit Committees. As with the 1998 Combined Code, companies are required to report on their compliance against the Code and should explain areas of non-compliance. The revised Combined Code is effective for Companies with financial years starting **on or after 1 November 2003**.

The new Code amounts to a significant revision of the 1998 Code. In particular the Code calls for:

- A separation of the roles of the Chairman and Chief Executive. The Chairman should satisfy the criteria for independence on appointment, but should not, thereafter, be considered independent when assessing the balance of board membership;

Milestones in UK Corporate Governance

- A Board of at least half independent NEDs. The Code defines independence as recommended by the Higgs Report;
- Candidates for Board selection to be drawn from a wider pool;
- the Board, its committees and directors to be subject to an annual performance review;
- at least one member of the audit committee to have recent and relevant financial experience; and
- In contrast to the Higgs Report, the revised Code permits the Chairman to chair the nominations committee, except where the committee is considering the appointment of the chairman's successor.

Myners Report (2004)

Paul Myners 'Review of the impediments to voting UK shares,' published in January 2004 for the Shareholder Voting Working Group, a network of investment industry and corporate bodies, was produced in response to the need to address concerns, 'that the system for voting the shares of UK issuers is not as effective and efficient as it should be.' Specifically, as stated in the Report, problems have arisen from the fact that the, 'process...is still quite manually intensive...the chain of accountability is complex...there is a lack of transparency and...there is a large number of different participants, each of whom may give a different priority to voting.'

While he states that if the existing paper-based system, which has a number of structural weaknesses, were to be, 'overhauled and upgraded,' it would lead to improvements being seen, his overriding conclusion is that, 'electronic voting remains the key to a more efficient voting system, and all parties – issuers, institutional investors and the intermediaries – need to make conscious efforts to introduce electronic voting capabilities in 2004.'

Further to this he recommends that, 'issuers in at least the FTSE 350, investment managers, custodians and proxy voting agencies should all have introduced the necessary system changes so that electronic voting capabilities are universally available (and) that beneficial owners...make direct and specific enquiries of their agents and others to establish the extent to which they have, or will have, introduced electronic voting capabilities to be used this year.'

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