Organisation for Economic Co-operation and Development

Organisation de Coopération et de Développement Économiques

Symposium on

The Role of Disclosure in Strengthening Corporate Governance and Accountability

"Corporate Governance in the United Kingdom"

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February 12 - 13 1998

Paris, France

Corporate Governance in the United Kingdom

Report for the OECD

DRAFT 1 21 September 1997

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1 Development of corporate governance in the UK

In December 1992, a Committee chaired by Sir Adrian Cadbury published a report which has provided a remarkably robust framework for the development of corporate governance in the United Kingdom. The official title of the Committee, which was jointly sponsored by the Stock Exchange, Bank of England, the Confederation of British Industry and institutional investor organisations, was the 'Committee on the Financial Aspects of Corporate Governance'. This title reflects the main reason for the formation for of the Committee, which followed a number of high profile corporate scandals and collapses. These were typically characterised by a combination of: fraud; inadequate financial controls and poor quality financial reporting; the concentration of boardroom power in the hands of dual role Chairmen/CEOs; weak and ineffective boards; and substantial investor losses.

In addressing the issues raised by these failures and wider investor concern and uncertainties about the standards of corporate governance in UK listed companies, the Cadbury Committee defined corporate governance as being 'the system by which companies are directed and controlled'. The Committee described the role of the board as being the governance of their companies, which includes 'setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship'. The corresponding corporate governance role of shareholders was defined by the Committee as 'to appoint the directors and auditors and to satisfy themselves that an appropriate governance structure is in place'. These roles and the duties of boards are to shareholders as a body, and not to any sub-group group of shareholders or even all shareholders at a particular time. Corporate governance as defined by the Cadbury Committee therefore implies continuing obligations on the part of the board and shareholders as legal groups whose rights and obligations are superior to those of their individual members. Under the UK system of corporate governance, the key rights of shareholders are either treated as equal (for example in the provision of information) or directly proportional to the number of shares owned in any given company. Both are applied to voting procedures at shareholder meetings.

The recommendations of the Cadbury Committee were summarised in a 'Code of Best Practice' (see box). Despite its brevity, the Code has been far reaching in its implications and has provided the foundation for the development of corporate governance in the UK - and also in other countries which have chosen to create their own corporate governance codes around the 'Cadbury model'.

Cadbury Code

Board of directors

- The board should meet regularly, retain full and effective control over the company and monitor the executive management.
- There should be a clearly accepted division of responsibilities at the head of the company, which will ensure a balance of power an authority, such that no one individual has unfettered powers of decision. Where the chairman is also chief executive, it is essential that there should be a strong an independent element on the board, with a recognised senior member.
- The board should include non-executive directors of sufficient calibre and number for their views to carry sufficient weight in the board's decision.
- The board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands. ◆
- There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense. ◆
- All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are followed and that applicable rules and regulations are complied with. Any question about the removal of the company secretary should be a matter for the board as a whole.

Non-executive directors

- Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.
- The majority should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement, apart from their fees and shareholding. Their fees should reflect the time which they commit to the company.
- Non-executive directors should be appointed for specified terms and reappointment should not be automatic. ◆
- Non-executive directors should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole.◆

This Chapter reviews corporate governance in the UK in the context of: the Cadbury Committee and the work of its two successor committees; the growth and structure of institutional investment in the UK stock market; the ownership of major listed companies. It also discusses the roles played by institutional investors as corporate monitors; the structure and role of the board; the recommendations of the Hampel Committee and the implications of these for further developments in the system of corporate governance in the UK.

Cadbury Code Continued ...

Executive Directors

- Directors' service contracts should not exceed three years without shareholders' approval. ◆
- There should be full and clear disclosure of directors' total emoluments and those of the chairman and highest-paid director, including pension contributions and stock options. Separate figures should be given for salary and performance-related elements and the basis on which performance is measured should be explained. ◆
- Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors. ◆

Reporting and controls

- It is the board's duty to present a balanced and understandable assessment of the company's position.
- The board should ensure that an objective and professional relationship is maintained with the auditors.
- The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties. ◆
- The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities. ◆
- The directors should report on the effectiveness of the company's system of internal control. ◆
- The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary. ◆

Note: Auditors are required to review the company's statement of compliance with regards to those items marked ◆.

2 Comparison with other systems

Although the UK system of corporate governance is often described as being part of the ‘Anglo-American’ model, this is usually done to characterise other systems of corporate governance as being both substantially different and as representing an alternative approach. Thus the Anglo-American model is contrasted with systems of corporate ownership and governance found in countries as diverse Japan, France and Germany. In this bimodal analysis of corporate governance, the UK and US are described as having ‘outside’ systems of corporate governance and those in Japan, France and Germany are seen, to varying degrees, as ‘insider’ corporate governance systems.

Insider systems are characterised as being based on long-term and therefore exceptionally stable relationships between companies and at least some of their major shareholders. These relationships may be purely financial but or based on past or current commercial relationships. The interests of large shareholders are often supported by board representation, either directly or through alliances with other shareholders. Thus insider shareholding and corporate governance systems are characterised by being part of extensive shareholder and board-level corporate networks. These provide a close-knit corporate governance structure, but one that may also serve to limit the rights and influence of shareholders and investors outside the core shareholder group. Detailed descriptions of the corporate governance systems of France (1997), Germany (1995) and Japan (1996) are provided in other OECD country Surveys.

The investment risks of the inside model include potentially limited accountability to shareholders outside the core insider group and the costs of self dealing if inside shareholder groups make private gains at the expense of other shareholders. These gains may be taken in the form of advantageous commercial relationships, capital or asset transfers, or the pursuit of broader political, economic or corporate agendas than would normally be required by companies in the course of business relationships and their the pursuit of long-term shareholder value.

In contrast to the inside system of corporate governance, the Anglo-American model is described as an ‘outside system’. In this, corporate ownership tends to be diffuse and dominated by institutional investors. In addition, formal and potentially enterprise distorting relationships between board members and individual or groups of shareholders is generally limited. Outside systems of corporate governance as practiced in the US and UK also appear to be more open and equitable in the distribution of information and corporate governance processes are more transparent, including board elections. The accountability of the board to shareholders as a body is also more clearly recognised.

But descriptions of corporate governance systems as being either insider or outsider based also group national systems which have evolved in different economic, corporate and investment cultures and which continue to do so. It is also arguable that the insider/outsider model of corporate governance is rapidly becoming a historical construct: under the impact of global capital flows into equity markets; in an investment environment in which common reporting standards are increasingly important; and leading institutional investors are starting to adopt a consistent approach to the evaluation of corporate governance issues and risks.

There are significant differences between the systems of corporate governance found in the US (see OECD US Survey, 1996) and the UK. However, the UK and US markets are also not entirely independent and the increasing level of investment by US institutional investors in non-domestic stock markets and the application to non-domestic markets of corporate governance standards consistent with those developed for US companies is likely to play an increasing role in the development of corporate governance standards in the UK and other economies.

Key features of the UK system of corporate governance include the: primacy of long-term shareholder interests; the equality of shareholders; importance of financial disclosure and transparency;

and the accountability of boards to shareholders. Whilst these are, for example, also evident in the US model of corporate governance, significant differences include: the almost total absence of shareholder lawsuits in the UK; the lack of a single SEC-type regulatory authority; the smaller size of the stock market; and the dominance of equity investment by a relatively small number of institutional investors.

3 Growth in Institutional Investment

Share ownership in the UK is characterised by: the domination of the domestic institutional investors of the stock market; a high degree of concentration in the ownership of listed companies by institutional investors; the virtual absence of corporate cross-holdings; and the declining role of private investors in share ownership. The concentration of ownership by institutional investors is significantly greater than that found in other major stock markets and has had a major influence of the development of corporate governance in the UK.

Between 1990 and 1995, the UK has seen the third highest increase in the financial assets of institutional investors in OECD countries, from $1,116.5 Bn in 1990 to $1,788.7 Bn in 1995 (Table 1). The UK accounts for an estimated 7.6% of institutional financial assets of OECD countries, with those in the US responsible for over half (50.8%) the OECD total and Japanese institutions for 16.9%. Although the growth in UK financial assets of 60.2% in US$ terms in the period 1990-1995 is below the OECD average of 68.8%, in sterling (£) terms the increase was 99.3% from £579 Bn to £1,154 Bn (Table 2). Only Korea (133.5%) and Italy (113.1%) showed greater increases in national currency values.

In 1990, UK institutional investors had the highest proportion of assets held in equities (66%), nearly three times the OECD country average of 23%. By 1995 the proportion in the UK had increased to 69%, still two and a half times the OECD average of 28%. The closing of this gap would suggest that whilst UK institutions appear to be approaching some kind of ceiling in their asset allocation towards equities, institutions in other OECD markets are gradually increasing their exposure to equities. For example, whilst the value of institutional holdings in the UK more than doubled (+108.4%) in the period 1990 - 1995, proportionally bigger increases were seen in the Australia, Germany, Italy, the Netherlands, Switzerland and the US.

4 Equity holdings of institutional investors

The status of equities as the asset class of choice of UK institutional investors is therefore both strong and long established. Other OECD data (Table 3) shows that in 1980 the aggregate (weighted) portfolio allocation of insurance (life and non-

Table 1. Institutional Investor Financial Assets

US $ Bn	**US $ Bn**	**% OECD**	**% GDP**	**% growth 1990 - 1995**	**Growth $ Bn 1990-1995**
Australia	264.4	1.1	75.9	88.5	124.1
Canada	492.2	2.1	87.9	47.8	159.2
France	1 158.8	5.0	75.3	83.4	527.0
Germany	1 132.2	4.8	46.1	85.8	522.8
Italy	222.9	1.0	20.6	52.0	76.3
Japan	3 953.5	16.9	77.4	62.8	1 525.1
Korea	263.1	1.1	57.7	116.0	141.3
Luxembourg	369.8	1.6	2 132.8	285.6	273.9
Netherlands	626.5	2.7	158.4	65.6	248.2
Sweden	265.0	1.1	114.8	34.7	68.3
Switzerland	239.2	1.0	150.5	-12.0	-32.6
UK	**1 788.7**	**7.6**	**162.3**	**60.2**	**672.2**
US	11 870.9	50.8	170.8	69.7	4 875.7
OECD total	23 387.6	100.0	n/a	68.8	9 532.4

Source: OECD Institutional Investors Statistical Yearbook 1997

Table 2. Institutional Investor Financial Assets and Equity Holdings

	Value of financial assets (currency)			% Equity value		Value of equities (currency)		
	1990	**1995**	% increase	**1990**	**1995**	**1990**	**1995**	% change
Australia	181	355	96.1	39	50	71	178	151.5
Canada	387	672	73.6	20	24	77	161	108.4
France	3 242	5 678	75.1	22	22	713	1 249	75.1
Germany	895	1 596	78.3	9	12	81	192	137.8
Italy	165 691	353 159	113.1	16	17	26 511	60 037	126.5
Japan	326 326	406 534	24.6	23	18	75 055	73 176	-2.5
Korea	87 291	203 854	133.5	19	13	16 585	26 501	59.8
Luxembourg	57	92	61.4	0	0	0	0	0.0
Netherlands	639	1 005	57.3	14	23	89	231	158.4
Sweden	1 121	1 764	57.4	28	35	314	617	96.7
Switzerland [1]	352	509	44.6	16	50	56	255	351.9
UK	**579**	**1 154**	**99.3**	**66**	**69**	**382**	**796**	**108.4**
US	6 996	11 871	69.7	23	36	1 609	4 274	165.6
			Average	23	28			

1. 1994 data
Source: OECD Institutional Investors Statistical Yearbook 1997

Table 3. UK Institutional investors

	1980		**1985**		**1990**		**1995**	
Life insurance total assets	**53 634**	100.0	**131 358**	100.0	**234 398**	100.0	**486 481**	100.0
Domestic equities	16599	30.9	47355	36.1	93369	39.8	225463	46.3
Foreign equities	2058	3.8	12278	9.3	20067	8.6	61294	12.6
Non-life insurance total assets	**11 640**	100.0	**22 942**	100.0	**40 361**	100.0	**64 204**	100.0
Domestic equities	2743	23.6	5896	25.7	9837	24.4	16832	26.2
Foreign equities	658	5.7	2210	9.6	3233	8.0	4554	7.1
Open-ended investment companies total assets	**6 114**	100.0	**21 372**	100.0	**45 639**	100.0	**110 709**	100.0
Domestic equities	3402	55.6	6234	29.2	26248	57.5	60433	54.6
Foreign equities	1086	17.8	444	2.1	13886	30.4	37526	33.9

Closed-end investment companies total assets	**8 755**	100.0	**18 125**	100.0	**20 659**	100.0	**45 255**	100.0
Domestic equities	4697	53.6	7733	42.7	10300	49.9	19544	43.2
Foreign equities	3054	34.9	7437	41.0	7448	36.1	20132	44.5
Pension funds total assets	**56 787**	100.0	**170 999**	100.0	**306 260**	100.0	**512 286**	100.0
Domestic equities	25726	45.3	84677	49.5	148360	48.4	261183	51.0
Foreign equities	3880	6.8	22998	13.4	48995	16.0	86177	16.8
Total assets	**136 930**	100.0	**364 796**	100.0	**647 317**	100.0	**1 218 935**	100.0
Domestic equities	53 167	38.8	151 895	41.6	288 114	44.5	583 455	47.9
Foreign equities	10 736	7.8	45367	12.4	93 629	14.5	209 683	17.2
Total equities	63 903	46.7	197 262	54.1	381 743	59.0	793 138	65.1

Source: OECD Institutional Investors Statistical Yearbook 1997; United Kingdom Table 1

life), investment companies (open-ended and closed-end) and pension funds was 46.7%. Of the £63.9 Bn held in equities by these investor classes, 16.8% was held in non-domestic companies, a proportion which increased to 26.4% by 1995.

There are however significant differences in the asset allocation strategies employed by institutional investors, with non-life insurance companies consistently showing the lowest investment levels in equities. In 1980 the proportion of their financial assets held in domestic company shares was 23.6% and non-domestic companies 5.7%. By 1995, these proportions had only increased marginally, to 26.2% and 7.1% respectively. In contrast, life insurance companies increased the proportion of financial assets held in the form of domestic equities by more than half, from 30.9% in 1980 to 46.3% in 1995. Their enthusiasm for overseas equities has been even greater, increasing more than threefold, from 3.8% (1980) to 12.6% (1995). The result is that the proportion of life insurance funds held in the form of equities in 1995 (58.9%) was nearly double that in 1980 (34.7%).

Autonomous pension funds, which accounted for 48.4% of total institutional equity holdings in 1980 (Table 4), then allocated 45.3% of their financial assets to domestic equities and 6.8% to non-domestic equities. The proportion held in domestic companies has increased relatively modestly since then, reaching 51% in 1995. As with life insurance funds, the enthusiasm for non-domestic equities has grown faster, from 6.8% to 16.8% in 1995, a total equity allocation of 57.8%. The proportion of total institutional equity funds attributable to pension funds declined to 43.8% in 1995, a function of the growing importance of life insurance companies and open-ended investment companies in the stock market.

Open-ended investment companies, known in the UK as unit trusts, in 1980 accounted for 6.4% of the stock market, increasing to 12.3% in 1995, two and a half times larger than closed-end investment companies (investment trusts). Both have a much higher proportion of assets held in non-domestic company shares than other types of institutional investment funds, but this has also been a long-established pattern. For example, in 1980, unit trusts held 55.6% of their assets in UK company shares, but this had even declined slightly to 54.6% by 1995. The fall in the investment trust sector was considerably greater, from 53.6% to 43.2% and it is notable that investment trusts now hold a higher proportion of assets in the form of non-domestic company shares (44.5%); in 1980 the proportion was 34.9%. During this period unit trusts doubled the proportion of assets held in non-domestic shares, from 17.8% to 33.9%.

5 Decline in personal equity holdings

UK surveys of share ownership based on the analysis of company share registers show similar trends and highlight the long-term decline in private share ownership in the UK (Table 5). In 1963 private shareholders (households) were estimated to directly own more than half (54%) the shares listed on the London Stock exchange by value. The decline over the following 30 years reduced this proportion to around 20% as collective investment schemes (including unit and investment trusts, insurance funds and pension funds) became more attractive as long-term savings vehicles. Factors contributing to this trend have included:

- Successive governments providing a more favourable tax environment for collective investment schemes than for direct holdings. Although the details of these tax benefits have been subject to change and continue to be so, the financial service industry has been adept at attracting retail savings into investment schemes based on their advantageous tax status, including certain insurance funds, Personal Equity Plans (PEPs) and portable personal pensions.

- Diversification of equity holdings. Although the number of individual private shareholders is estimated to have tripled from around three to ten million during the 1980s through the impact of the UK government's privatisation programme, most of the new shareholders failed to create even modest equity portfolios through taking direct holdings in non-privatisation companies through the secondary market. Instead there has been significant growth in unit trusts, which provide much wider diversification and also may offer exposure to overseas companies, which few individuals or households could comfortably achieve on their own account.

- The growth of private pension provision, primarily through the corporate sector, although personal pension schemes are now also widely used by the self-employed for retirement provision.

- The growth in the equity funding requirements of UK companies, which have issued shares to institutional investors in the primary market and which have contributed to the volume of equity-based collective investments managed by institutional investors.

Table 4. Types of institutional investment fund

	1980	1985	1990	1991	1992	1993	1994	1995
Life insurance	31.2	31.2	29.7	31.0	32.4	34.2	35.2	36.2
Non-life insurance	5.2	3.9	3.4	2.9	2.5	2.6	2.7	2.7
Open-ended investment	6.4	4.1	10.5	10.2	10.4	11.5	11.8	12.3
Closed-end investment	8.8	5.1	4.6	4.2	4.6	4.4	5.2	5.0
Autonomous pension funds	48.4	55.7	51.8	51.7	50.1	47.3	45.0	43.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
% total UK stock market			**64.7**	**66.4**	**67.6**	**70.2**	**66.7**	**67.4**

Source: OECD Institutional Investors Statistical Yearbook 1997; United Kingdom Table 2

Table 5. Share register analysis

	1963	1969	1975	1981	1989	1994
Pension Funds	6.4	9.0	16.8	26.7	30.6	27.8
Insurance Companies	10.0	12.2	15.9	20.5	18.6	21.9
Unit Trusts	1.3	2.9	4.1	3.6	5.9	6.8
Investment Trusts	11.3 }	10.1 }	10.5 }	6.8 }	1.6	2.0
Other Financial Institutions	}	}	}	}	1.1	1.3
Total UK institutional investors	29.0	34.2	47.3	57.6	57.8	59.8
Overseas Investors	7.0	6.6	5.6	3.6	12.8	16.3
Total institutional investors	**36.0**	**40.8**	**52.9**	**61.2**	**70.6**	**76.1**
Individuals	54.0	47.4	37.5	28.2	20.6	20.3
Others	10.0	11.8	9.6	10.6	8.8	3.6
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: ONS 1994

Table 6. Share ownership by investor and company type (1994)

	Market average	Privatised companies	FT-SE 100 only	Non-FTSE 100
Pension Funds	27.8	27.8	69.9	30.1
Insurance Companies	21.9	21.7	69.1	30.9
Unit Trusts	6.8	6.0	50.7	49.3
Investment Trusts	2.0	1.8	47.3	52.7
Overseas Investors	16.3	13.6	75.9	24.1
Individuals	20.3	22.6	60.5	39.5
Others			55.8	44.2
Total	100.0	100.0		

Source: ONS 1994

Although successive ONS surveys of the beneficial ownership of UK companies have not analysed non-domestic beneficiaries in terms of beneficiary type, it is generally accepted that the bulk of these shareholdings are controlled by foreign institutional investors and only a small proportion directly by private individuals.

The US accounts for nearly half (46.3%) of the total of 16.3% of the stock market attributable to foreign beneficiaries, according to the most recent (1994) ONS survey. Of the balance, 17.8% is attributable to EU investors, equivalent to 2.9% of market capitalisation. The sum of overseas and UK institutional holdings was over three-quarters (76.1%) of stock market value at the end of 1994. Overseas investors have a slightly below average weighting in privatised companies (13.6%), but there is little difference in the profile of UK institutional investors (Table 6). It is evident that by the end of 1994, the shareholder profile of privatised companies was close to the market average and that a high proportion of the shares acquired by individuals at the time of privatisation had been subsequently purchased by institutional investors in the secondary market. Non-domestic institutions are however more heavily invested in FT-SE 100 companies than domestic investors, with domestic unit and investment trusts most weighted to companies outside the FT-SE 100 (Table 6).

The role of institutional investors in the ownership of listed companies in the UK is significantly more that that in the US (47.5%), France (44.4%) and Germany (34.6%) (Table 7). In the US, the majority of non-institutional investor shares are held by households; in France by households and as corporate cross-holdings; and in Germany by corporate cross holdings. Even allowing for the higher level of institutional ownership in the UK, the largest UK institutional investors play a proportionately greater role in the ownership of listed companies. In the UK, the top 25 institutional investors (ranked by value of equity holdings) control 41.7% of the value of shares held by institutional investors. In the US (35.2%), France (32.5%) and Germany (27.4%) the proportions are all lower.

Similarly, the proportion of the shares in the top 25 companies controlled by their largest 25 institutional investors is significantly higher in the UK than in other markets (Table 8). Combining this analysis with the market value of the Top 25 companies provides an index of ownership concentration. This shows (Table 9) that the top 25 institutional shareholdings in the top 25 companies had a value

Table 7: Institutional Investors' share of stock markets

	US	**UK**	France	Germany
All Institutions as % of market	47.5	**76.5**	44.4	34.6
Top 25 Institutions as % of market	16.7	**31.9**	14.4	9.5
Top 25 Institutions as % of institutions	35.2	**41.7**	32.5	27.4

Sources: The Conference Board using data from stock markets and CDA Spectrum (July 1997)

Table 8. Top 25 Corporations' Institutional Investors

	US	**UK**	France	Germany
Top 5	12.7	**16.4**	15.9	7.0
Top 10	18.3	**24.6**	19.5	10.2
Top 20	25.1	**34.7**	22.6	13.5
Top 25	**27.5**	**41.4**	**23.5**	**14.5**

Source: The Conference Board using data from CDA Spectrum (July 1997)

Table 9. Top 25 companies and top 25 institutional investors

	US	**UK**	France	Germany
Top 25 companies as % of stock market	16.6	**37.8**	51.5	36.8
Top 25 Institutions as % of market	16.7	**31.9**	14.4	9.5
% Market value of Top 25/25 holdings	4.6	**15.6**	12.1	5.3

Sources: The Conference Board using data from stock markets and CDA Spectrum (July 1997)

Table 10: Shareholdings of institutional investors by market capitalisation

Capitalisation	**Largest**	**Top 5**	**Top10**	**Top 20**
> £5 billion	6.5	17.6	26.0	36.3
£2 - 5 billion	9.0	21.6	30.8	42.4
£1 - 2 billion	8.3	24.3	34.8	47.6
£500m - £1bn	9.9	27.4	37.9	50.4
< £500m	10.6	28.5	39.8	52.5

Analysis based on data from Citywatch

equivalent to 15.6% of the stock market in the UK, three times the corresponding proportion in the US (4.6%).

6 Ownership of listed companies

The concentration of ownership is strongly related to market capitalisation. The larger the company, the more dispersed the ownership amongst institutional investors. Table 10 sets out the average holdings of the largest and the top 5, 10 and 20 shareholders in the 300 largest listed companies. This shows that whilst the average largest holding in a company with a market capitalisation of over £5 billion is 6.5%, this rises to 10.6% for companies with capitalisations below £500 million. This size effect is found amongst all companies' top 20 shareholders, with more concentrated ownership consistently being found in smaller companies.

The ownership of between 20% and 30% of major listed companies by their five largest institutional shareholders has important implications for the relationships between these investors and the companies in which they hold stakes. Although this pattern of ownership could be described as potentially leading to or creating a controlling coalition, these institutional investors are also in competition with one another. Although they may have broadly similar investment objectives, this does not routinely lead to the formation of shareholder alliances. Nevertheless, should a coalition of a company's top five or ten shareholders be formed, it is clear that this will potentially provide a high level of influence over the board and probably de facto control of the company, given the diffuse ownership outside the coalition group.

This degree of concentration has been a key influence on the development of corporate governance in the UK. This has been supported by a number of major institutional investors creating dedicated corporate governance teams who are: increasingly coordinating their corporate governance policy frameworks with other institutional investors; responsible for internal liaison with portfolio managers; and may also have the authority directly communicate with companies.

Although exact rankings vary over time, particularly through mergers leading to the aggregation of equity portfolios, Table 11 sets out a number of measures of concentration for the Top 20 institutional investors in January 1996. This and other analyses of institutional investors' portfolios consistently show that the top ten institutions in 1996 accounted for approximately 25% of stock market value; the top 20 for one third and the top 50 institutions for half of stock market value. The institutional investors are ranked by: the estimated proportion of the UK stock market under management; the proportion of holdings in top 300 companies which exceed five percent; the proportion of holdings in which the institutional investor is more than two times overweight; a measure of portfolio concentration (Gini coefficient); and the proportion of top 300 companies in which the institutional investor is ranked as one of the top five institutional shareholders.

There is considerable consistency between these concentration measures, but five fund managers (Standard Life, BZW, Legal & General, Hermes and ESN) have much lower levels of portfolio concentration than other institutions. These are either index fund managers or have similar investment strategies to those followed by index fund managers. Particularly notable is the high proportion of companies in which the largest investors are found amongst companies' top five shareholders. Across the stock market, the largest institutional investors are consistently companies' largest shareholders. Even if their investment strategy is to selectively invest individual portfolios, the size of funds under management combined with the range of clients for which they act results in the same institutional investors holding substantial stakes in many companies. This result is that most major companies have broadly similar ownership profiles and in aggregate institutional investors' holdings in these are not strongly differentiated.

This is consistent with the finding that the shareholdings of the largest institutional investors in individual companies are also characterised by their stability and not their volatility. An analysis of the top ten shareholders in twenty of the UK's largest listed companies shows that in a two year period, there was very little net change in the aggregate size of these shareholdings. In December 1994 the average combined shareholdings were 23.1% but the shareholdings of the same institutional investors had fallen by only one-twentieth, to 21.9% two years later.

Table 11. Top 20 Fund managers

	Average shareholding (market weighting)	Proportion of shareholdings over 5%	Proportion of holdings over 2 times overweight	Concentration index (Gini Coefficient)	Proportion of companies ranked in top 5 shareholders
MAM	4.5	31.3	15.5	0.6	54.5
Prudential	3.1	23.5	15.0	0.5	59.7
Schroder	2.9	21.3	18.6	0.7	42.2
Standard Life	2.3	0.8	3.5	0.5	32.1
PDFM	2.0	14.3	18.5	0.7	26.0
BZW	1.9	0.6	3.5	0.3	25.3
Legal & General	1.8	0.3	3.5	0.3	15.9
Hermes	1.5	0.3	1.3	0.2	10.8
Threadneedle	1.3	4.7	16.2	0.7	14.4
Gartmore	1.3	9.2	23.8	0.7	17.9
Fleming	1.3	4.8	20.9	0.7	18.2
M&G	1.1	12.8	30.5	0.8	19.2
Scottish Widows	1.1	1.5	16.3	0.7	9.8
Morgan Grenfell	1.0	3.3	18.7	0.6	10.8
Norwich Union	1.0	2.4	17.1	0.8	8.8
AMP	1.0	0.9	24.1	0.6	7.1
CIN	0.9	0.7	22.2	0.7	4.7
Sun Life IM	0.9	1.4	17.5	0.7	6.4
ESN	0.9	0.1	4.8	0.4	1.3
Co-operative Ins.	0.9	0.4	12.3	0.5	2.0
Total	32.7				

Source: Analysis based on Citywatch data (January 1996)

Although individual shareholdings changed significantly more than this, the amount of buying and selling by companies top ten shareholders was almost balanced and led to only a small decrease in the average holding, from 2.3% to 2.2% over the two year period.

The top ten or twenty institutional investors therefore dominate the ownership of major companies and are consistently their largest shareholders and this has a significant influence on the structure and management of company - shareholder communications and relationships.

7 Corporate monitoring

It is extremely unusual for either individual institutional shareholders or a group of institutions acting as a definable group to be directly represented on the boards of UK companies. Although companies' largest institutional shareholders may be consulted before a board appointment is made, this is an informal process and does not lead to the widespread placing of institutional appointees on UK boards. Institutions do not therefore routinely have direct access to company boards, board decision making processes or information provided to the boards of companies in which they are shareholders. The influence of institutional investors on non-executive (outside) board appointments is much lower than in many other EU countries, according to a recent survey (Table 12). This is perhaps even more surprising given the dominant role of institutional investors in the UK compared to other EU markets.

Table 12: Sources of influence on the appointment of non-executive directors

Board type	CEO/ Chairman	Nominating committee	Full Board	Institutional Investors
Germany #	42	38	50	58
Northern Europe #	60	37	73	57
UK	73	52	65	4
Southern Europe	43	9	34	11
France & Belgium #	56	33	78	44

Supervisory boards only Source: Korn/Ferry

The lack of direct shareholder representation at board level, combined with the over-riding legal obligation on companies not to selectively provide shareholders with price sensitive information have led to a two-tier system of shareholder communications and shareholder relationships which recognise both the legal requirement to keep shareholders equally informed and the concentration of ownership found in many companies.

The Cadbury Committee described how 'shareholders have delegated many of their responsibilities as owners to the directors who act as their stewards. It is for the shareholders to call the directors to book if they appear to be failing in their stewardship and they should use their power'. The Committee identified the companies' Report and Accounts and Annual General Meetings (AGMs) as key mechanisms in board accountability to shareholders, but also recognised that 'the way institutional shareholders use their power to influence the standards of corporate governance is of fundamental importance'.

The role of the AGM and other shareholder meetings in corporate governance and investor communications has long been debated in the UK and in 1995 was the subject of a Report on 'Developing a Winning Partnership'. This made a series of recommendations (see box) based on the concept of model institutional investors, companies and pension fund trustees, which it was hoped would lead to improvements in both the quality, consistency and transparency of company - shareholder relationships. Whilst these recommendations were generally supported and have provided a broad best practice framework for investors and shareholders, the recommendations have no regulatory standing and failed to resolve the problem that AGMs seldom provide a focus for board accountability to shareholders. In its report the Myners Committee commented that 'virtually all participants in our consultation exercise viewed the AGM as presently constituted as an expensive waste of time and money'. This is consistent with research into the sources of information rated as useful by institutional investors and analysts (Table 13), in which AGMs and other shareholder meetings are notably absent.

Table 13: Most useful sources of information for institutional investors

Source	%	Source	%
Brokers	85	Newspapers	28
Annual reports	85	Companies' customers	26
Direct contact	80	Journalists	23

In-house research	62	On-line systems	23
Company presentations	62	Press releases	17
Companies' competitors	46	IR managers	11

% institutions taking part in survey: Source: Dewe Rogerson (1995)

Far from providing a focus for board accountability for shareholders, most companies find that their AGMs are rarely attended by institutional investors or their representatives. Instead those present are predominately private investors with small shareholdings and who are therefore entirely unrepresentative of shareholders as a body. The quality of discussions at shareholder meetings is

Myners Committee recommendations

The model **institutional investor**:

- Is more open in discussions with company management about corporate strategy and objectives, including a candid assessment of management's performance.
- Articulates its investment objectives to corporate management so that the is mutual understanding of expectations.
- Plays an active role in corporate governance including, for example, voting at AGMs.
- Improves training for individual fund managers to promote better industry knowledge and commercial awareness.
- Sets an agenda for meetings and ensuring adequate preparation by its representatives.

The management of the model **company**:

- Makes an annual strategic presentation to institutional investors and stockbrokers analysts. This includes a clear statement of management's vision for the company, corporate objectives and financing policies, and details of capital and revenue investment plans.
- Improves meetings with shareholders by focusing on long-term issues.
- Recognises the importance of the annual report and accounts as a means of communication and the need to keep abreast of best practice in disclosure.
- Communicates regularly throughout the year, including quarterly trading updates.
- Makes the effort to make AGMs an interesting and rewarding experience for participants. This includes encouraging shareholders to submit questions in advance, referring minority interest questions for later response and arranging presentations by operational management.
- Provides a comprehensive training programme for managers involved in investor relations.
- has a clearly defined and articulated policy for management remuneration.

The model trustee board of a **pension fund**:

- Establishes long-term goals which are framed in terms of risk and reward and reflect the liabilities of the fund.
- Sets objectives which are sufficiently long-term to encourage the manager to back his judgement on companies.
- Ensures that individual trustees have sufficient expertise to set appropriate objectives and to monitor performance through improved training in investment matters.

therefore usually low and the routine absence of major shareholders means that this is unlikely to change. Despite the small proportion of equity capital represented at shareholder meetings, many companies put considerable effort into information provided at AGMs. Companies involved in ethically sensitive business areas or regions not infrequently find themselves the subject of more coordinated private shareholder action, but these experiences only underline the gulf between the formal role and legal status of the AGM and current usage.

Institutional investors fail to attend AGMs because the accountability of companies to their major shareholders is through private one-on-one meetings. These may be held at any time but most often are organised in the period immediately following results announcements. In a typical investor relations programme, companies will arrange to meet their largest institutional shareholders in the week following the preliminary announcement of their financial results. The number of meetings held will depend on the size of the company, location of investors and whether there are any particular issues to discuss relating to, for example, corporate performance, strategy, succession planning or boardroom structure.

Such meetings will most often be attended by the CEO and Finance Director and sometimes also the Chairman, particularly if this is an executive post. Most institutional investors are concerned that they should not be provided with price sensitive information at these meetings, which could bar them from trading the company’s shares until the information is made public. It has been argued that these sensitivities significantly inhibit the quality of discussion between companies and their major shareholders and that this leads to excessive caution in the exchange of information between them.

Meetings with institutional investor meetings therefore tend to focus on longer-term issues to do with corporate strategy, financial risks and factors that may affect future business performance. Corporate governance is not a routine matter for discussion and will normally only be raised if the institutional investor has particular concerns. This is most likely if they believe that the issue is pertinent to the long-term performance of the company. Institutional investors therefore do not apparently consider corporate governance to be a core investment issue, but do recognise that it can be important. In such circumstances they are likely to first discuss their concerns in private meetings before attempting to co-ordinate their views and, if subsequently necessary, put public pressure on boards through contact with the media. This approach to corporate governance is in its initial stages characterised by:

- Institutional investors bypassing the AGM and other shareholder meetings as forum for board accountability
- Private one-on-one meetings with companies
- Limited coordination between institutional investors
- The chilling of non-executive directors

As commercially competitive organisations, institutional investors have limited interest in working closely with each other on a regular basis. In response, two representative organisations, the National Association of Pension Funds (NAPF) and Association of British Insurers (ABI) have created corporate governance frameworks for use by their members. These have provided minimum standards in some areas, including share option scheme performance targets and the definition of directors’ responsibilities.

Since the publication of the Cadbury Code, a number of institutional investors have published their own corporate governance policies to guide their actions and provide evidence to clients (primarily the trustees of private and public sector pension funds and their advisors) that they have a structured approach to corporate governance issues. Most of these are modelled on the codes and guidelines published by the ABI, NAPF, Cadbury and Greenbury Committees, although the latter was solely concerned with the issue of boardroom pay. In 1997, one of the more detailed and progressive corporate governance codes was published by Hermes (see box).

The institutional investor policies and codes that have been published are primarily concerned with: board membership, particularly the number of non-executive directors; whether or not the board roles of Chairman and CEO should be combined; the incentive arrangements designed to align the financial interests of executive directors and other employees with those of shareholders; the length of executive directors' contracts and their employment termination rights; the issuing of new shares; and the exercising of voting rights.

The policies are varied in length, internal consistency and their degree of prescriptiveness. Those issued by institutional investors (particularly those managing equity portfolios on behalf of pension fund clients) tend to emphasise the need for flexibility and the importance of applying their policies in ways appropriate to each company's particular circumstances. However, many companies apparently do not believe that institutional investors are sufficiently flexible in pursuing these objectives. Such inflexibility, is described by the Hampel Committee, the second successor to the Cadbury Committee and which published its draft Report in August 1997, described as 'box ticking'.

Key points from Hermes Corporate Governance Code

- Minimum of three fully independent NEDs on each board.
- Power of joint Chairman/CEOs to be balanced by Senior NED/Deputy Chairman and 'strong quorum' of independent NEDs.
- All directors to be re-elected at three year intervals. Directors over 70 every year.
- Maximum of three x three year appointments. NEDs on boards for ten years should no longer be regarded as independent.
- CEOs can only become Chairman and executive directors NEDs after a break in service.
- NEDs should receive half their post-tax remuneration in shares to be held until they leave the board. But no share options, bonus or free shares for NEDs.
- No political donations.
- Charitable donations permitted only if reasonable in value and have public relations value.
- In hostile takeovers, bidding companies should be forced to set out the rationale in terms of enhanced shareholder value.
- Hermes will support hostile bids where justified by bidding company and they have lost confidence in the management of target company.
- Increased disclosure of proxy votes (including abstentions) and electronic voting supported.
- Opposed to ownership structures not based on one-share-one vote and share issues which do not respect pre-emption rights.

8 Shareholder resolutions

Under UK company law, shareholders have limited rights but these include: the right to receive the Annual Report and Accounts; attend shareholder meetings or appoint a representative to do so; vote on resolutions; submit resolutions and call shareholder meetings in certain circumstances; receive dividends; and to freely transfer ownership of their shares.

AGMs provide the focus for many of these rights. Although Annual Reports and Accounts must be published at least 21 days before the AGM, shareholders are routinely asked by boards to vote to receive or adopt the Report and Accounts. This may be required under companies' Articles of Association, although there is no legal requirement for them to do so. Shareholders will normally also be required to vote on: the payment of the dividend proposed by the board; the election or re-election of directors to the board; the reappointment of the auditors;

Table 14: Analysis of shareholder meeting resolutions (1996)

Type of resolution	%
Appointment of Directors	30.71
Auditors	10.76
Adoption of Report and Accounts	10.52
Disapplication of Pre-emption Rights	10.00
Ordinary Dividends	8.74
Share Issues (Section 80 Authorities)	7.83
Options and Long Term Incentive Plans	4.53
Share Buy-backs	3.98
SAYE Schemes	1.92
Scrip Dividends	1.35
Articles of Association	0.69
Profit Sharing Schemes	0.25
Acquisition	0.19
Memorandum of Association	0.04
Disposal	0.04
Unclassified	8.46
Total (4 750)	100.00

Source: Manifest Voting Agency

changes to the company's articles and statutes; changes to the authorised share capital or authority to buy-back shares; and employee share schemes and board incentive arrangements. An analysis of 4,750 resolutions put to shareholders in 1996 is shown in Table 14.

The authority to vote generally rests with the legal owner of companies shares, and with respect to managed funds (insurance, pension, unit and investment trusts) this power is normally held by the organisation responsible for day to day management of the fund. This arrangement is designed to simplify fund management responsibilities and rights attaching to the legal title and beneficial ownership of shares. In some cases fund managers may be required to refer to fund beneficiaries or trustees, for example when proposing to vote against the recommendations of a company's board.

Institutional investors use their corporate governance policies and codes to guide their voting actions, but cast their votes by proxy as they do not personally attend shareholder meetings. Proxy votes are lodged with the companies registrars and normally appoint the meeting chairman to vote the shares as directed. Although these votes are routinely counted before shareholder meetings, a high proportion of shareholder resolutions are passed by a 'show of hands' by those shareholders and their representatives present at the meeting. The show of hands is based on the principle of one shareholder - one vote, and not on voting power being proportional to the number of votes held. In many shareholder meetings the proxy votes lodged by institutional investors and others remain uncast and there is no formal record which takes into account the votes which would have been cast by absent shareholders had a full vote been taken.

Research suggests that although there has been an improvement in recent years, in the 1997 voting season, only half the votes of institutional investors were cast. However, it also appears that it is companies' largest institutional shareholders are the most diligent in voting their shares. This raises the question as to whether voting is a fiduciary duty on the part of managed funds and whether pension funds in particular should be required by law to vote on all resolutions.

A criticism of the Hampel Committee that institutional investors cast their proxy votes with insufficient reference to companies' specific circumstances and vote against boards when a more careful an analysis of these circumstances would lead to a different decision. Whilst this may be a legitimate cause for concern, an analysis by PIRC of voting at 1997 shareholder meetings shows that not a single board resolution was rejected and that the average vote against board resolutions was only 1.0%, up from 0.68% in 1996.

9 Informal Sources of Control

This suggests that the concerns of the Hampel Committee about 'box ticking' may be less directed at voting itself than at other corporate governance processes, and in particular at the power of institutional investors to put private pressure on companies to make corporate governance and other reforms. Evidence from the media suggests that companies are being subject to increasing informal pressure from their major shareholders.

However, the direct pressure put on boards by institutional investors to make changes in the governance, management and structure of the companies (for example through:, the appointment of additional non-executive directors; the replacement of the CEO; demerging autonomous divisions) can have uncertain outcomes and boards may resist making the changes that shareholders have signalled they believe are necessary. Such pressure can also create moral hazards for the institutional investor, particularly those managing the pension fund assets of other listed companies. Pressure is most likely to be applied after a period of sustained under-performance (typically of three years or more) and in the absence of reforming actions by the board itself. However, recently listed companies may be an exception to this pattern and appear to be subject to institutional pressure earlier if prospectus forecasts are not met.

Reputational and internal costs of intervention may be high and the time required of key executives and portfolio managers are key factors when an institutional investor assesses whether it should: sell some or all of its shares in an under-performing company; remains a passive investor; or commit internal resource and become an 'active investor'. Internal opportunity costs are likely to be higher than any cash outlay (for example in legal costs) and how much time is spent on a company and how closely the institutional investor works with competitor institutions has to be carefully judged. Other issues that will be taken into account include:

- The size and value of the shareholding relative to the company and institution's total equity portfolio.
- The status of the investment in the portfolio.
- The length the investment has been held.
- Assessment of the company's long-term prospects and the relationship between these and the investors assessment of current problems/concerns.
- Position in the company's share register and size of shareholding relative to other investors.

The approach taken by institutional shareholders is therefore a function of many factors, both internal - in terms of management time and investment strategy - and external, to do with a company's performance and prospects. The Cadbury Committee described the readiness of institutional investors to become active shareholders and to use their power to influence standards of corporate governance as turning 'on the degree to which they see it as their responsibility as owners, and in the interest of those whose money they are investing, to bring about changes in companies when necessary, rather than selling their shares'.

The degree of convergence in the portfolios of the largest institutional investors is a function both of the size of funds under management and the quarterly measurement of pension fund performance against standard market indices such as the FT-SE 100 index. Institutional investors operating actively managed equity portfolios have to construct their portfolios both to avoid under-performance and excessively volatile but above-average portfolio returns. Over the last three years these constraints have caused some of the UK's largest fund active fund managers to under-perform their performance benchmarks, but have created fewer problems for those which tend to more closely track the market in terms of stock selection and portfolio weightings.

This performance divergence is may well result in a further shift of pension fund assets into passively managed index funds, in which transaction and management costs are significantly lower. Although estimates vary, it is likely that around 20% of pension fund equity portfolios are currently indexed (or effectively so) and index funds are also now being actively promoted to retail investors in the form of Personal Equity Plans (PEPs) and unit trusts. The requirement to maintain near to market weightings in the UK's major companies (the FT-SE 100 accounts for approximately 75% of market value) is possibly a bigger influence on institutional investor's corporate governance policies than the explanation that they hold stakes 'too large to sell'.

10 Shareholder resolutions

The preference of institutional investors to maintain their freedom of action and to conduct their relations with companies 'behind closed doors' is highlighted by their aversion to formally putting their proposals to other shareholders in the form of shareholder resolutions. This prohibits shareholders as a body voting, for example, on: whether a CEO should be replaced; the post of Chairman and CEO should be split; or the board encouraged to increase the number or proportion of non-executive directors. Although the Department of Trade and Industry (DTI) circulated in a paper in 1996 discussing legal and regulatory changes that would make it easier for shareholders to submit and promote their own resolutions the DTI proposals were primarily directed at facilitating the process for private shareholders. Institutional shareholders were assumed not to require any additional incentives or support.

Institutional shareholders privately pursue their interests and those with the largest shareholdings would appear to do so most diligently. The process largely excludes institutional shareholders outside the top ten or twenty and private shareholders as well. The interests of these 'outside' shareholders therefore depend on a combination of: their transfer rights (to sell their holdings); free-rider benefits from the actions of other shareholders; and the ability of the board to competently weigh the judgements of one group of shareholders against their legal duties to their shareholders as a body.

11 Board Structure

The Cadbury Committee focused its attention on the structure and membership of the board as being key to effective corporate governance. The boards of UK companies are characterised by being equally composed of executive and non-executive directors. Although board size increases with company size (by turnover) these proportions remain approximately constant (Table 15).

Table 15: Board size and composition

Company size (turnover)	Whole board	NEDs	% NEDs
> £2bn	11.9	6.3	53
£501m - £2bn	9.0	4.5	50
£201 - £500m	7.7	3.5	45
£101 - £200	7.5	3.6	48
£26 - £100m	6.5	3.2	49
<£25m	5.5	2.7	49
Average	7.4	3.6	49

Source: ProNed/Egon Zehnder (1997)

Table 16: Average board size

	Board type	Average board size
Germany	Management	4.6
	Supervisory	13.3
Northern Europe	Management	6.6
	Supervisory	8.9
UK	Unitary board	10.1
Southern Europe	Unitary board	9.0
France/Belgium	Unitary/management board	12.1
	Supervisory board	9.0

Source: Korn/Ferry

Table 17 Companies with joint Chairmen/CEOs

Company ranking	% with joint Chairman/CEO
1 - 250	17
251 - 500	18
501 - 1 250	24
1 251 - 1550	28

Source: Committee on the Financial Aspects of Corporate Governance (1995)

A survey of board size amongst larger listed companies in EU countries shows that UK boards is comparable in size to those elsewhere in the EU (Table 16).

The Cadbury Committee was particularly concerned with the concentration of boardroom power when the Chairman is also the CEO. This had been a feature of several of the corporate collapses which had led to the formation of the Committee. Although the Committee did not propose that combining the roles should be prohibited, it strongly recommended that ‘there should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision’. In companies where the roles are combined the Committee said that ‘it is essential that there should be a strong and independent element on the board, with a recognised senior member’.

Five years later, one of the concerns of the 1997 Hampel Committee with ‘box ticking’ is that institutional investors and some company advisors have too rigidly interpreted the Cadbury Code and have treated the Committee’s recommendation as a corporate governance requirement. There is evidence that the proportion of boards with combined Chairman and CEO roles has declined since 1992, particularly in larger companies. But three years after the Cadbury Report was published, many boards retained combined roles, particularly those of smaller companies (Table 17) where the Chairman/CEO may be seen as the key driving entrepreneurial force.

The Hampel Committee in its draft Report argued this point more strongly, saying that 'a number of companies have combined the two roles successfully, either permanently or for a time. We do not therefore think that the separation of the two roles should be made a firm rule'. At the same time, The Hampel Committee proposes that all boards should have a publicly identified 'lead non-executive director' even when the posts of Chairman and CEO are separated.

12 Non-executive directors

The Cadbury Committee believed that non-executive directors should play a key role in corporate governance processes and in its draft report proposed a stronger separation of the roles of executive and non-executive directors than set out in the final report. UK law recognises no distinction in the legal responsibilities or liabilities of executive and non-executive directors, yet it is clear that within the structure of the unitary board there are differences between the roles which must be balanced and managed by the Chairman. The calibre of non-executive directors is clearly critical and the Cadbury Committee said that they 'should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct'.

To this end, the Committee defined the role of the board Chairman as being 'primarily responsible for the working of the board, for its balance of membership, subject to board and shareholders approval, for ensuring that all the relevant issues are on the agenda, and for ensuring that all directors ... are enabled and encouraged to play their full part in its activities'.

Whether this is achieved depends substantially on the process through which non-executive directors are selected and their ability to be independent. Cadbury made two key recommendations about the appointment of non-executive directors; that there should be a formal selection process and that the appointment should be a matter for the whole board. These proposals were intended to reduce the scope for personal patronage on the part of elements on the board, which could compromise the independence and effectiveness of both individual non-executive directors and the board as a whole. There is certainly evidence that non-executive directors feel that they have greater independence when the Chairman is independent of company management and the roles of Chairman and CEO are not combined (Table 18).

The issue of the independence of non-executive directors has yet to be fully resolved in the UK. The Hampel Committee refers to the need for 'vigorously independent non-executive directors', but this combines two meanings of independence which may be better separated when considering the selection of non-executive directors (their independence from potential conflicts of interest)

Table 18: Influence of non-executive directors

Power of independent directors to …	Independent Chairman	Combined roles
Control directors' compensation	92	76
Affect strategy 3-4 years ahead	92	79
Change under-performing directors	90	80
Affect strategy 1-2 years ahead	90	75
Address shareholders direct	85	60
Force a change of professional advisors	84	78
Influence media/City perceptions of Company	68	40

Source: Top Pay Research Group (1996)

and their role on the board (independence of mind). Institutional investors have been primarily concerned with the former definition and the Cadbury Committee recommended that the majority of non-executive directors should be 'independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement, apart from their fees and shareholding'. It also said that it was boards to decide whether this definition was met and the Hampel Committee also supports this view. However, at least some institutional investors are seeking to develop a minimum standard of non-executive director independence, for example Hermes (see p 24 opposes: the reappointment of retiring executive directors as non-executive directors; the direct promotion of the CEO to the position of Chairman; and the retention of non-executives after nine or ten years on the board.

13 Board Committees

Whilst keeping its proposals consistent with the principles of the unitary board and single-legal status directors, the Cadbury Committee also sought to develop the monitoring role of non-executive directors through requiring companies to establish audit committees composed of at least three non-executive directors and which excludes executive directors. This established a corresponding requirement for a minimum of three non-executive directors on the board. The apparent inability of smaller companies in particular to meet this standard is the biggest reason why companies fail to meet the standards set by the Cadbury Committee.

Despite the opportunity to treat smaller companies (normally defined as those ranked below the FT-SE 350 index) as a special case, the Hampel Committee argued that 'the need for a robust independent voice on the board is as strong in smaller companies as in large ones. In many smaller companies the executives are also major shareholders; and the level of external scrutiny by the market is low. Non-executive directors do a vital job in safeguarding minority interests and ensuring good governance'. Nevertheless, and consistent with its aim of encouraging greater flexibility by shareholders and institutional investors in particular, Hampel also puts the issue of the number of non-executive directors in the context of 'the need to consider the governance arrangements of smaller companies with flexibility and proper regard to individual circumstances'.

Although the minimum standards proposed by the Cadbury that boards should have at least three non-executive directors and at least two independent non-executive directors have not been universally achieved, almost all companies now have audit committees and the majority also have remuneration and strategy. The proportion of companies with audit, remuneration and nomination committees has increased substantially since 1992. Although there was also an increase in the number of boards with special strategy sub-committees between 1992 and 1994, there was no significant increase between 1994 and 1996 (Table 19). The propensity to have strategy committees also does not appear to be associated with company size (Table 20). In 1996 there did however appear to be size effect for remuneration committees, which the Greenbury Committee proposed in 1995. This is likely to have been at least partly caused by smaller companies taking longer to respond to the Greenbury Committee and the proportion of companies of all sizes with remuneration committees is now likely to much higher.

Table 19: Companies reporting non-executive involvement in board committees (%)

Committees	1992	1994	1996
Audit	55	89	95
Remuneration	77	89	90
Nomination	n/a	36	46
Strategy	60	71	72

Source: ProNed/Egon Zehnder (1996)

Table 20: Companies reporting non-executive involvement in board committees (%)

Company size (turnover)	Audit	Remuneration	Nomination	Strategy
> £2bn	96	96	87	74
£501m - £2bn	98	92	73	80
£201 - £500m	98	95	60	72

£101 - £200	100	93	44	69
£26 - £100m	95	91	34	72
<£25m	87	79	23	69
Average	95	90	46	72

Source: ProNed/Egon Zehnder (1996)

14 Boardroom Pay

Although the issue of board remuneration was addressed by the Cadbury Committee and it recommended that: there should be a minimum level of disclosure of the value of each element of the remuneration and benefits of the Chairman and highest paid director; service contracts should be for a maximum of three years; boards should establish remuneration committees consisting either wholly or mainly of non-executive directors; and that this should be chaired by a non-executive director, the issue of boardroom pay was not central to its remit as the Committee on the Financial Aspects of Corporate Governance.

Two years later, in 1994, the issue of boardroom pay became the subject of intense media and political interest. Public dissatisfaction about the remuneration of ‘fat cat’ directors had been fuelled by growing disquiet amongst utility company customers about the growth in the value of share options granted to executive directors of privatised companies. With the support of the government, the CBI sponsored the formation of a special Study Group to look into the issue. The Group’s Chairman was Sir Richard Greenbury and the Group was thereafter known as the Greenbury Committee. The Committee reported in July 1995 and made a number of significant recommendations about corporate governance and reporting issues relating to directors’ remuneration. Key requirements were that: boards should establish Remuneration Committees composed only of non-executive directors; the Committees would be directly accountable to shareholders; a comprehensive report should be included in companies’ Annual Report and Accounts setting out both remuneration policy and the individual pay elements (including basic pay, annual bonuses, long term incentive schemes, share options, benefits and change in the value of pension rights) for each director; and that shareholder approval would be necessary for the granting of option, share-based and other forms of long-term incentive schemes.

The Greenbury Committee also suggested that option schemes may be less appropriate than other forms of long-term incentive and more closely geared to company share prices and shareholder returns. This subsequently led to the government imposing a ceiling of £30,000 on the value of new options that could be granted to a director. Other issues addressed included the length of directors’ contracts; termination arrangements; and disclosure requirements with respect to changes in the value of directors’ pension rights.

In structure and detailed content, the Greenbury Committee has had a marked impact on the level of disclosure about the processes by which executive remuneration is set by UK boards and the amount of information directly available to shareholders in the Annual Report and Accounts. Although the Hampel Committee has apparently had little impact on the growth in value of boardroom pay, public concern about the remuneration of utility company directors has attenuated as a result of takeovers and mergers reducing both the number of companies and directors exercising one-off pre-privatisation option grants.

15 Current issues

The system of corporate governance currently operating in the UK is based on the responsibility of unitary boards to shareholders as a body and a framework composed of Codes, recommendations, Stock Exchange regulations and Company Law. In its draft report, the Hampel Committee questioned whether this framework is making a positive contribution to business prosperity and whether there is any 'hard evidence to link [business] success to good governance' and 'rules and regulations about structure will deliver success'. However, it is also notable that the report provides no evidence to support its assertions that current corporate governance codes and standards or that the use of these by institutional investors has inhibited business prosperity or corporate performance. Key to the Committee's fifty specific recommendations (see Appendix) for the reform of corporate governance is a rejection of prescriptive framework setting about the standards of corporate governance that companies should adopt. Instead, the Committee emphasises the potential benefits of allowing boards to develop their own standards, disciplines and models of corporate governance. The proposals of the Hampel Committee provide a basis for reporting to shareholders, but are also designed to restrict and frustrate the imposition of what may be inappropriate modes of corporate governance by institutional investors or groups of shareholders who do not share the boards' responsibilities, but nevertheless are the body to which boards are responsible.

The draft report produced a wide range of reactions and has been criticised for potentially weakening the current corporate governance framework. Although the Committee recommends 'that companies should include in their annual report and accounts a narrative statement of how they apply the relevant principles to their particular circumstances' this is seemingly diluted by the Committee also saying that 'this should not be an additional regulatory requirement, nor do we prescribe the statement's content'. Separately, the Committee proposes that its final report should include a 'super' governance Code, combining its own recommendations with those parts of the earlier Cadbury and Greenbury Codes that it believes should be retained. The proposed Super Code is not included in the draft report and it remains unclear how the need to combine flexibility and accountability will be applied to the prior Codes, which are now being widely followed by companies and which are also incorporated in Stock Exchange Listing Rules.

The Hampel Committee's recommendations at draft report stage should be put in the context that its membership is dominated by seven chairmen and CEOs of listed companies. There are only two representatives from the fund management industry, but none of the top 20 institutional investors set out in Table 11 were represented, nor any of the organisations (including the ABI and NAPF) which represent the interests of institutional investors. The impact of the Hampel Committee's draft report will depend on: the final text due for publication in December 1997; the response of institutional investors; and the response of the government. After 18 months of deliberation, reviewing 140 written submissions and over 200 meetings, it is unlikely that comments received on the draft report will fundamentally change the Hampel Committee's proposals.

Although the Hampel Committee recognises that institutional investors 'are not a homogenous group' and have different investment objectives and time horizons, it also suggests that the ABI and NAPF should work with institutional investors to 'eliminate unnecessary variations' in their corporate governance and voting guidelines. Whilst encouraging greater uniformity in the approach taken by institutional investors to corporate governance issues, the Committee is also strongly encouraging much greater flexibility on the part of institutional investors when they assess the corporate governance standards of the companies in which they hold shares.

Several issues need to be considered when assessing whether institutional investors are likely to comply with this objective. The first is that most of the guidelines developed by institutional investors for their own use already emphasise the need to take each companies' specific circumstances into account when reviewing standards of corporate governance. How this flexibility is applied depends on the relationship between a number of complex issues, including: the level of detail contained in the guidelines; past experience of corporate governance activity; the importance attached to particular aspects of corporate governance; company specific factors; and investment strategy. It is inevitable that the result will be considerable diversity in institutional investors' policies and actions with respect to those companies where there is specific cause for concern; whether this is in response to a prolonged period of prolonged under-performance or a management team or board which appears to be placing insufficient emphasis on shareholders' long-term interests.

A second issue is whether institutional fund managers will seek to build competitive advantage through promoting their approach to corporate governance and incorporating this within their investment models. This could be done through a number of investment strategies, including: investing only in companies with high standards of corporate governance on the basis of recognised benchmarks; investing in companies which have recently improved their standards of corporate governance; or focusing on companies with a combination of poor performance and low standards of corporate governance. In the US the latter have become the targets of so-called 'activist' funds, but the impact of such funds on UK companies has so far been limited.

However, there are signs that US institutional investors are preparing to apply their corporate governance standards to non-domestic companies. In early 1997 CalPERS (California Public Employees Retirement System) issued a set of corporate governance standards applicable to companies in the UK, although it has said that it does not expect to use these with respect to individual companies until 1998. CalPERS is also playing a significant role in the development of the International Corporate Governance Network, which provides a forum for institutional investors to discuss common interests.

Present trends in the UK suggest that the approach taken by institutional investors will continue to develop, but may not be unduly influenced by the Hampel Committee. Although the publication of a governance 'Super-Code', particularly if adopted by the Stock Exchange, will provide a framework for the development of investors' individual codes, principles and guidelines, it is likely that these will become more differentiated over time and therefore fail to provide the level of consistency that the Hampel Committee believes is desirable.

Whether the Stock Exchange adopts the proposals put forward by the Hampel Committee in its final report may in part be influenced by the government's policies and legislative proposals with regard to corporate governance. These have yet to be articulated, although the formation of an 'expert committee' on corporate governance was proposed in the Labour Party's 1997 election Manifesto. It is possible that such a committee will be formed after the Hampel Committee has published its final report.

16 Summary and conclusions

[To be discussed]

Appendix 1:
Summary of Recommendations of the Hampel Committee (draft Report)

BOARD RESPONSIBILITIES

- Executive and non-executive directors should continue to have the same duties under the law.
- Management has an obligation to provide the board with appropriate and timely information. This is essential if the board is to be effective.

BOARD STRUCTURE

- There is overwhelming support in the UK for the unitary board and virtually none for the two tier board.
- To be effective, non-executive directors need to make up at least one third of the membership of the board.
- The majority on non-executives should be independent. This applies for companies of all sizes. The separation of the roles of chairman and chief executive should not be a firm rule and in a number of companies the combination of the roles can be justified. But separation is to be preferred, other things being equal, and companies should justify a decision to combine the roles.
- Whether or not the roles of chairman and chief executive are combined, there should be a lead non-executive director other than the chairman, who should be identified in the annual report.

APPOINTING DIRECTORS

- Companies should set up a nomination committee to make recommendations to the board on all new board appointments.
- People drawn from a wider range of backgrounds are able to make a real contribution as non-executive directors.
- Boards should appoint as executive directors only those executives whom they judge able to take a broad view of the company’s overall interests. All directors should submit themselves for re-election at least every three years, and companies should make any necessary changes in their Articles of Association as soon as possible.
- There should be no fixed rules for the length of service or age of non-executive directors: but there is a risk of their becoming less efficient and objective with length of service and advancing age and boards should be vigilant against this.

TRAINING & ASSESSMENT

- Directors should undergo appropriate instruction when first appointed to a board and subsequently as necessary.
- Boards should consider introducing procedures for assessing their own collective performance and that of individual directors.

REMUNERATION COMMITTEES

- Boards should establish a remuneration committee, chaired by a non-executive director, to develop policy on remuneration and devise remuneration packages for individual directors. These should then be recommended to the board who should decide. The board itself should devise remuneration packages for non-executive directors.
- Companies should not be obliged to seek shareholder approval for either remuneration packages or the remuneration report.

REMUNERATION POLICY

- Companies should be cautious in the use of inter-company comparisons and remuneration surveys in setting levels of directors remuneration.
- The Greenbury code provisions for performance related pay should not be further refined. Instead, remuneration committees should use their judgement to devise schemes appropriate for the specific circumstances of the company. The total rewards from such schemes should not be excessive.
- There is no objection to paying a NED's remuneration in the company's shares, but this is not recommended as universal practice.

CONTRACTS AND TERMINATION

- As recommended by Greenbury, there is a strong general case for setting directors' contract periods at one year or less, but in some cases two years may be acceptable.
- There is an advantage is dealing with a director's early departure by agreeing in advance on the payments to which he or she would be entitled in such circumstances.
- Shareholders can reasonably expect a director who resigns before the expiry of his term to give an explanation.

DISCLOSURE

- The requirement for directors to include in the annual report a general statement on remuneration policy should be retained. These statements should be more informative.
- Disclosure of individual remuneration packages should be retained, but this has become too complicated.
- The requirement to disclose details of individual remuneration should continue to apply to overseas based directors of UK companies.
- The requirement to disclose the pension implications of pay increases is supported, but companies should make clear that changes in transfer values cannot be meaningfully aggregated with annual remuneration.

INSTITUTIONAL SHAREHOLDERS

- Pension fund trustees should encourage fund managers to take a long view in managing their investments.
- Companies and institutional shareholders should adopt the recommendations of the 1995 report 'Developing a Winning Partnership'.

GUIDELINES AND VOTING POLICIES

- The ABI and NAPF should examine the problem caused by the existence of different and incompatible shareholder voting guidelines.
- Institutional investors have an obligation to their clients to adopt a considered voting policy on voting their shares, but voting should not be compulsory.

SHAREHOLDER MEETINGS

- Notice of the AGM and related papers should be sent to shareholders at least 20 working days before the meeting.
- Boards should provide a full business presentation at the AGM, with a question and answer session.
- The decision on who should answer questions at the AGM is one for the Chairman; but it good practice for the chairman of the audit, remuneration and nomination committees to be available.
- The Chairman should provide written answers to significant questions which cannot be answered on the spot.
- Companies should prepare a resume of discussion at the AGM and make this available to shareholders on request.

VOTING PROCEDURES

- DTI proposals made in 1996 to reform the law relating to shareholder resolutions, proxies and corporate representatives should be implemented.
- Companies should establish in-house nominees in order to restore the rights of private shareholders who use nominees.
- Shareholders should be able to vote separately on each substantially separate issue. The practice of bundling unrelated proposals in a single resolution should cease.
- Companies should count all proxy votes and announce the proxy count on each resolution after it has been dealt with on a show of hands.

AUDIT COMMITTEES

- Each company should establish an audit committee of at least three NEDs; at least two of them independent and chaired by a NED. There should be no relaxation of this rule for smaller companies, but shareholders should also consider cases of difficulty on their merits.
- The requirement on directors to include a ‘going concern’ statement in the annual report should be retained.

INTERNAL CONTROLS

- The term ‘effectiveness’ should be removed from point 4.5 of the Cadbury Code, which would then only require the directors to report on the company’s system of internal control.
- Directors should maintain and review controls relating to all relevant control objectives, and not merely financial controls.
- Companies which do not already have a separate internal audit function should regularly review the need for one.

REPORTING BY AUDITORS

- There should be no additional requirement for auditors to report on governance issues, nor should any of the existing requirements be removed.
- Auditors should also report on internal control privately to the directors, which allows for an effective dialogue to take place and for best practice to evolve in preference to prescription.

RELATIONSHIP WITH AUDITORS

- The professional bodies concerned should reduce the ten percent ceiling on the proportion of audit income which an audit firm may earn from one audit client.
- Audit committees should keep under review the nature and extent of non-audit services provided by the auditors, to ensure a balance between the maintenance of objectivity and keeping costs to a minimum.
- Auditors are inhibited from going beyond their present functions by concerns about the law on liability. Account should be taken of these concerns by professional bodies and when making changes in the law.