



Corporate Governance: A Subject Whose Time Has Come



Learning Outcomes

In which we see how corporate governance has evolved:

- All corporate entities need governing
- Corporate governance is old, only the phrase is new
- The early days: merchants and monopolists
- The invention of the limited-liability company
- The separation of ownership from operations
- Developments in the 1970s: audit committees, two-tier boards and corporate responsibility
- Developments in the 1980s: corporate collapses
- Developments in the 1990s: corporate governance codes arrive
- Developments early in the 21st century: reactions to more corporate collapses
- Corporate governance implications of the global financial crisis
- New frontiers for corporate governance

All corporate entities need governing

The 20th century saw massive growth in serious management thought. Organization theories acquired new significance, although the board of directors did not appear on most organization charts. Strategic management has made great strides, but the contribution of the board seldom received a mention. Important theories and practices were developed for the management of finance, marketing, and operations, although little concern was shown for the role of the directors. This was the era of management theories, management consultants, management gurus, and management teaching, all reflecting a preoccupation with management.

However, if management was the focal point for the 20th century, corporate governance is set to be the primary focus for the 21st. Almost all advanced and advancing economies have introduced corporate governance codes or enacted new company laws, as in the United States following the Enron debacle. The global financial crisis starting in 2007 added further strands to corporate governance policy and practice. We will be studying these developments later.

All corporate entities, including profit-orientated companies, both public and private, joint ventures, cooperatives, and partnerships, and not-for-profit organizations such as voluntary and community organizations, charities, and academic institutions, as well as governmental corporate entities and quangos,¹ have to be governed. All need a governing body. In the case of a company, this is its board of directors. Other corporate entities may call their governing body a council, a court, a committee, a board of governors, or, in the case of some Oxford colleges, just the governing body. To avoid repetition, from now on we will refer to all governing bodies as 'boards' and their members as 'directors', since many of the essential principles and practices apply, whatever names are used.

Essentially, corporate governance is about the way power is exercised over corporate entities. It covers the activities of the board and its relationships with the shareholders or members, and with those managing the enterprise, as well as with the external auditors, regulators, and other legitimate stakeholders.

Corporate governance is different from management. Executive management is responsible for running the enterprise, but the governing body ensures that it is running in the right direction and being run well. Directors are so-called because they are responsible for setting the organization's direction, formulating strategy and policymaking. Further, the board is responsible for supervising management and being accountable. Overall, the board is responsible for the organization's decisions and its performance.

Corporate governance is old, only the phrase is new

The idea of governance at the level of government is ancient. Chaucer (c.1343–1400), the English writer, philosopher, and courtier, used the word, although he could not decide how it should be spelt ('gouernance', 'governaunce'). But the phrase '*corporate governance*' did not come into use until the 1980s. However, it has been quickly adopted worldwide. In 1988, Cochran and Wartick published an annotated bibliography of corporate governance publications; it had 74 pages. Today, Google accesses over 12 million references to corporate governance and Bing 23 million. Research into corporate governance also began to develop in the late 1980s. The research journal *Corporate Governance—An International Review* was founded in 1992.

Yet, although the theoretical exploration of the subject is relatively new, the practice of corporate governance is as old as trade. Shakespeare (1564–1616) understood the problem. In his play *The Merchant of Venice*, Antonio the merchant agonized as he watched his ships sail out of sight, having entrusted his fortune to others. With a sole trader or a small family firm, there is seldom any real separation between management and governance; changes in strategic direction merge with the day-to-day running.

Whenever a principal has to rely on agents to handle his or her business, governance issues arise. This agency issue has long been recognized and has become a central challenge in the running and regulating of modern enterprise today.

¹ An acronym meaning quasi-autonomous non-governmental organization.

In this chapter, we trace the evolution of corporate governance ideas and practices over the years from the governance of merchant ventures, through companies set up by trading empires, to the brilliant invention of the limited-liability company in the 19th century, which opened the door to the bludgeoning ambiguity, complexity, and rapid changes in corporate governance today. The underlying ideas and concepts of corporate governance have been slow to evolve, with the underpinning legal frameworks still owing more to mid-19th-century thinking than to the realities of complex modern business. We shall also see how changes are often responses to critical situations rather than developments in theory.

The early days: merchants and monopolists

In medieval Europe, craft guilds for each trade, such as weavers, tailors, and wheelwrights, enforced standards, regulated prices, and controlled training and entry to their trade. Guilds were incorporated by charters or similar legal processes by cities or states. Only masters of the trade could be members of the guild and only guild members could practise that trade. Guild members elected the guild's governing body.

By the 17th century, economic, political, and military competition was growing between the empires of Britain, Holland, Portugal, and Spain. Companies created by charter from the monarch or the state, pursued trading interests under rules set by the charter. In 1600, England's Queen Elizabeth I granted a royal charter to the East India Company, giving it a monopoly over all trade between England and Asia. The Company was a joint-stock company, with over 1,000 stockholders, who elected a governing board of 24 directors each year. The company traded principally with India and China in cotton, silk, tea, and opium, at one time administering parts of the British Indian Empire with a private army. The Dutch East India Company was granted a charter by the Republic of the Netherlands in 1602 to run Dutch colonies and to trade with Asia. The Dutch West India Company was chartered in 1621 to run the slave trade between Africa, the Caribbean, and North America. The Hudson Bay Company received its royal charter in 1670, when Prince Rupert, cousin of King Charles II, saw the opportunities for fur trading in the Hudson Bay area of what is now Canada.

As we shall see, the story of corporate governance has many overambitious and dominant businessmen with unrealistic expectations, leading to corporate collapses and, sometimes, fraud. The South Sea Company was incorporated in 1711 to trade with Spain's South American colonies, mainly in slaves. In 1718, King George I of England became governor of the company, bringing prestige and confidence. Then, in 1720, the British House of Lords gave a monopoly to the company on the understanding that the company undertook to guarantee the British national debt at a fixed interest rate. Massive speculation in its stock followed: stock prices went from £100 to over £1,000. Then the bubble burst. The Chancellor of the Exchequer was found to have taken bribes to inflate the stock. Many of the British gentry lost their fortunes, banks failed, while directors of the company were imprisoned and their wealth confiscated.

Very much as during the recent global financial crisis, when some banks collapsed and had to be bailed out by governments, there was an outcry against such corporate excesses and risks. Adam Smith (1723–1790), a moral philosopher at the University of Glasgow, argued that society benefits when individuals pursue their own self-interest, because the free market then produces the goods and services needed at low prices. He is considered by many to be the

father of modern economics.² But he was suspicious of businessmen, as many academics are to this day. His oft-quoted comment on their behaviour offers a classic corporate governance perspective:

The directors of companies, being the managers of other people's money rather than their own, cannot well be expected to watch over it with the same anxious vigilance with which (they) watch over their own.

Adam Smith, *The Wealth of Nations*, 1776

The invention of the limited-liability company

At the start of the 19th century, apart from corporations created by the crown or the state, there were basically three ways in which people could engage in business: as a sole trader, in a partnership, or as an unincorporated body in which some managed the firm while sleeping partners just provided finance. In each case, if the business became insolvent, the creditors could pursue their debts with any and all of those involved until ultimately they became bankrupt. In those days, not paying your debts was a crime leading to debtors' prison, followed by the possibility of your wife and children being sent to the parish workhouse. This was quite a disincentive to invest unless people were directly involved in the management activities. But this was a period of great economic growth, generated by the Industrial Revolution. Firms needed external capital to expand faster than ploughed-back profits would allow. Moreover, the emerging class with an income from rent had funds available.

The French were the first to create a form of corporate incorporation, which restricted shareholders' liability. From 1807, the *Société en commandité par actions* limited the liability of external investors, but executive directors still remained personally exposed to their companies' debts. Meanwhile, in Britain, the need for companies to access capital without exposing external investors to the threat of bankruptcy was debated in Parliament. Some members of Parliament called for a form of incorporation that mirrored the French system. But in the event, the British Companies Acts of 1855 and 1862 gave limited liability to all shareholders, whether they were involved in the management of the company or not.

It proved to be one of the finest systems ever designed. The key concept was the incorporation of a legal entity, separate from the owners, which nevertheless had many of the legal property rights of a real person—to contract, to sue and be sued, to own property, and to employ. Yet the shareholders were no longer responsible for the company's debts. The company had a life of its own, giving continuity beyond the life of its founders, who could transfer their shares in the company. Nevertheless, ownership remained the basis of power. Shareholders elected their directors, who owed a stewardship duty and reported to them. The concept of ownership and shareholder rights is still the underpinning of modern company law, although the reality of power over many large companies is now very different.

² Adam Smith (1776; 1976) *The Wealth of Nations*, revised edn., George J. Stigler (ed.), University of Chicago Press, Chicago.

During the 19th century, some states in the United States passed legislation allowing the incorporation and control of companies. In New York, Wall Street financial institutions were financing and trading the shares of companies formed to build railways and to develop industry in the growth years that followed the American Civil War (1861–1865). But legislators were suspicious of limiting shareholders' responsibility for their companies' debts. Moreover, the objectives of each company and its life span were defined, and one company could not own another. The industrial age brought great wealth to some American companies and their owners. Subsequently, state constitutions were amended and laws rewritten to be more amenable to these powerful companies. Shareholder limited liability was introduced. Charter battles were fought to allow conglomerates, in which companies owned other companies. Eventually, corporate charters ceased to limit companies' activities and their life spans.

In 1918, the right of individual states to regulate their companies was challenged at the federal level. The court in the state of New Hampshire had revoked the royal charter given to Dartmouth College by the English King George III, but the US Supreme Court overruled the lower court. Many states saw this as a federal attack on state sovereignty and rewrote their laws to circumvent the Dartmouth ruling (see Friedman, 1973). To this day, companies in the United States are incorporated at the state not the federal level.

The concept of the limited-liability company spread throughout the British Empire of the late 19th century. The company laws of Australia, Canada, some Caribbean islands that are now tax havens, India, Malaysia, New Zealand, Singapore, South Africa, and other African countries still reflect those origins, although they have subsequently evolved to reflect local circumstances. However, although these countries' laws evolved to reflect their changing situations, in many cases Commonwealth case law can provide precedents. Hong Kong, while now a special administrative region of China, still retains its British-originated company law and legal system.

The notion of the limited-liability company was elegantly simple and superbly successful, leading to huge industrial growth around the world, and the creation of untold employment and wealth. Unfortunately, the elegance of the mid-19th-century model now bears about as much relationship to reality as a hang-glider does to a fleet of jumbo-jets. Nevertheless, the original corporate concept remains the essential basis of contemporary company law.

Initially, though, all joint-stock, limited-liability companies were public companies—that is, they could invite the public to subscribe for their shares. Their main purpose was to raise capital from the public, who were no longer responsible for their company's debts. By the early 20th century, however, business people saw that the model could be used to give limited liability to family firms and other private businesses, even though they did not need access to capital from outside investors. Such private companies, incorporated in jurisdictions around the world, now far outnumber public companies.

The separation of ownership from operations

In the early days, limited-liability companies were relatively small and simple. Shareholders were drawn from the wealthier classes and could attend or be represented in annual general meetings of the company. They were relatively close to the companies in which they had invested. In those days, there were no chains of financial institutions, pension funds, hedge funds, brokers, or agents between the investor and the boardroom.

But by the early years of the 20th century things were changing. In the United States, the United Kingdom, and other economically advancing countries, many companies had become large and complex. Their shareholders were now numerous, geographically widespread, and differed in both their time horizons and their expectations about dividends and capital growth. Shares in most public companies were now listed on stock exchanges. Chains of financial institutions and other intermediaries stood between companies and the votes of their shareholders in company meetings. Links between management and investors in their companies were becoming distant.

Using data from companies in the United States, Berle and Means (1932) drew attention to the growing separation of power between the executive management of major public companies and their increasingly diverse and remote shareholders. They realized the significance of corporate power, observing that:

The rise of the modern corporation has brought a concentration of economic power which can compete on equal terms with the modern state—economic power versus political power, each strong in its own field. The state seeks in some aspects to regulate the corporation, while the corporation, steadily becoming more powerful, makes every effort to avoid such regulation . . . The future may see the economic organism, now typified by the corporation, not only on an equal plane with the state, but possibly even superseding it as the dominant form of social organisation.

(Berle and Means, 1932, revised edn 1967)

This was a seminal work of corporate governance (although that was not a phrase Berle and Means used), and is still one of the most frequently cited works in corporate governance writing today. The recognition of issues raised by this work was instrumental in the creation of the US Securities and Exchange Commission. Berle and Means left a vital intellectual inheritance for the subject. It is surprising that it was so long before it was taken up.

For the next forty years, the work of directors and boards remained the province of jurisprudence, enlivened by anecdote and exhortation. In 1971, a pioneering work by Mace, based on research in US companies, sought to discover what directors really did and, in the process, challenged the conventional wisdom:

In most companies boards of directors serve as a source of advice and counsel, serve as some sort of discipline, and act in crisis situations if the president dies suddenly or is asked to resign because of unsatisfactory management performance.

The business literature describing the classical functions of boards of directors typically includes three important roles: (1) establishing basic objectives, corporate strategies, and board policies; (2) asking discerning questions; and (3) selecting the president.

(Instead) I found that boards of directors of most large and medium-sized companies do not establish objectives, strategies, and policies however defined. These roles are performed by company management. Presidents and outside directors generally agreed that only management can and should have these responsibilities.

A second classical role assigned to boards of directors is that of asking discerning questions—inside and outside the board meetings. Again it was found that directors do not, in fact, do this. Board meetings are not regarded as proper forums for discussions arising out of questions asked by board members.

A third classical role usually regarded as a responsibility of the board of directors is the selection of the president. Yet it was found that in most companies directors do not in fact select the president, except in . . . crisis situations . . .

Mace (1971)

Developments in the 1970s: audit committees, two-tier boards, and corporate responsibility

Three significant developments occurred in corporate governance thinking in the 1970s. In the United States in 1972, the Securities and Exchange Commission required listed companies to create audit committees, as standing committees of the main board comprising independent outside directors. These audit committees were to provide a bridge between the external auditor and the main board, ensuring that directors were made aware of any issues that had arisen between the auditor and the company's finance department. In Europe, two-tier boards were promoted, and on both sides of the Atlantic debates arose around board duties towards other stakeholders.

An increasingly litigious climate in the United States, with shareholders of failed companies seeking recompense from directors, boards, and, in particular, auditors (whose indemnity insurance was seen to provide a 'deep pocket' to be emptied for shareholders' benefit) led to more emphasis on checks and balances at board level. Auerbach (1973) wrote of the audit committee as a new corporate institution. Meutz and Neumann (1970, 1977) discussed the practicalities of audit committees. In the UK, Tricker (1978) undertook a study of British board structures, membership, and processes, intending to advocate audit committees in the UK, but concluded that, although many listed-company boards did have non-executive directors, the concept of director independence was not understood in Britain. Sir Brandon Rhys-Williams, a British member of Parliament, also called for non-executive directors and audit committees in the UK, a proposal that led to a Green Paper *The Conduct of Company Directors* (1977) and a parliamentary Bill calling for audit committees, which ultimately failed.

The European Economic Community (EEC)³ issued a series of draft directives on the harmonization of company law throughout the member states. The EEC Draft Fifth Directive (1972) proposed that unitary boards, in which both executive and outside directors were responsible for seeing that the business was being well run and run in the right direction, be replaced by the two-tier board form of governance practised in Germany and Holland. In this form of governance, companies have two distinct boards, with no common membership. The upper, supervisory board monitors and oversees the work of the executive or management board, which runs the business. The supervisory board has the power to hire and fire the members of the executive board.

The idea of the two-tier board was not well received in Britain—partly because it would replace the unitary board, which was seen, at least by directors, as a viable system of governance.

³ Subsequently renamed the European Union.

Moreover, in addition to the separation of powers, the directive included co-determination ideas then practised in Germany, in which the company was seen as a partnership between capital and labour with the supervisory board made up of equal numbers of shareholder and employee representatives. The UK's response was the report of the Committee chaired by Lord Bullock. *The Report of the Committee of Inquiry on Industrial Democracy* (1977) and the research papers (1976) associated with it reflected the first serious corporate governance study in Britain. The Committee's proposal, for a continuation of the unitary board, but with worker representative directors, was not well received in Britain's boardrooms either.

The 1970s also saw a questioning of the role of the major corporation in society. Broadly, the argument was made that public companies have responsibilities beyond their prime legal duty to their shareholders. Given the scale and significance of such companies, boards should report and, some argued, be accountable to a range of stakeholders who could be affected by board decisions—customers, suppliers, and others in the added-value chain, employees, the local community, and the state. In the United States, there was an important dialogue between the American Bar Association, looking for an alternative basis of power over companies, and the Corporate Roundtable representing directors' convictions of the value of the existing model. Consumer advocate Ralph Nader offered a specification for a model corporation rooted in stakeholder thinking. Jensen and Meckling (1976), whose work was subsequently to become crucial to the development of agency theory, asked whether the concept of the company could survive.

The debate was picked up in the UK. A committee of the Confederation of British Industries, chaired by Lord Watkinson (1973), reported on the wider responsibilities of the British public company. A report by Fogarty (1975) discussed companies' responsibilities and stakeholder participation. The Accounting Standards Steering Committee produced *The Corporate Report* (1975), which called for all economic entities to report publicly and accept accountability to all those whose interests were affected by the directors' decisions. The political implications of these proposals for the widening of accountability and control over companies, and the related erosion of managerial power, soon consigned this report to the archives.

Meanwhile, a number of corporate governance problems featured in the reports of inspectors appointed by the UK government Department of Trade. The inspectors at Pergamon Press (1971) concluded that owner Robert Maxwell should not again run a public company—advice that was subsequently ignored, enabling him to build a media empire that collapsed dramatically twenty years later. Other inquiries, which examined board-level problems at Rolls Royce (1973), London and County Securities (1976), Lohmro Ltd (1976), and others, all added to the interest in the way companies were governed, although commentators still spoke of the way they were managed.

Developments in the 1980s: corporate collapses

In the 1980s, broader stakeholder concerns became overshadowed by the market-driven, growth-orientated attitudes of Reaganite and Thatcher economics. Directors' responsibility to increase shareholder value was reinforced. The profit performance model became the basis for the privatization of state-run entities—rail, coal, electricity, gas, and water enterprises were all privatized in the UK and, gradually, around the world. The threat of predator takeover

bids (the market for control) was presented in Anglo-American circles as an essential incentive for strong board-level performance. Hostile bids, at this time, were often financed through the newly available high-risk, high-rate 'junk' bonds.

By the late 1980s, the downside of such thinking was becoming apparent. In the United States, the names of Ivan Boesky, Michael Levine, and Michael Milken were to go down in the annals of corporate governance with the massive, junk-bond-financed, insider information deals through Drexel, Burnham, and Lambert. In Australia, the names of Alan Bond, Laurie Connell of Rothwells, and the Girvan Corporation were being associated with questionable governance practices. In Japan, Nomura Securities was accused of having too close links with its regulator, having offered well-paid sinecures to senior bureaucrats on retirement (called *amakudari*—literally 'descent from heaven'). Lavish payouts to major institutional clients to cover losses and links with a *yakuza* underworld syndicate were also alleged. The presidents of Nomura Securities and Nikko Securities resigned; so did Nomura's chairman, who also stood down from vice-chairman of the *Keidanren*, the federation of Japanese economic organizations.

In Australia, a 1989 report from the National Companies and Securities Commission⁴ on the collapse of Rothwells Ltd, a listed financial institution, commented that 'at no time did the board of Rothwells perform its duties satisfactorily'. The company was dominated by an entrepreneurial figure, Laurie Connell, who expanded the company with acquisitions providing loans to many companies on the second board of the Western Australia Stock Exchange that were newer, smaller, and more entrepreneurial than those on the main board. Many were also riskier, but Connell financed them, acquiring the title 'Last Chance Laurie' in the process. The stock-market collapse in 1987 provided the catalyst that finally brought the company down, although earlier the auditors had refused to sign the 1988 accounts, and the official report disclosed 'massive private drawings by Connell and the rearrangement of affairs so that no disclosure of loans to directors had to be made'.

In the UK, it was the Guinness case and, subsequently, the collapse of Robert Maxwell's companies.⁵ Boards dominated by powerful executive directors were now seen to need checks and balances, particularly where the posts of chief executive and chairman of the board were combined and the outside directors were weak. The concepts of corporate governance were at last to become the focus of attention; indeed, the phrase itself was about to appear.

In the mid-1980s, research into corporate governance expanded: for example, Baysinger and Butler (1985), using the phrase 'corporate governance', looked at the effects on corporate performance of changes in board composition, and Mintzberg (1984) posed the question 'Who should control the corporation?' But the subject came centre stage less as the result of academic, research-based deliberations, and more as a result of official inquiries set up in response to the corporate collapses, perceived board-level excesses, and apparently dominant chief executives in the later part of the 1980s.

In the United States, boards and their directors were coming under pressure. Institutional investors became increasingly proactive in corporate governance. Drucker (1991) drew attention

⁴ Now the Australian Securities Commission.

⁵ See Case study 1.1

to the potential governance power in shareholders' proxy votes. Companies needed to influence their share prices and to tap the ever-increasing pension funding and savings around the world. Expectations of institutional investors for performance improvement grew, along with pressure to end corporate governance practices that benefited incumbent boards and reduced the probability of the company being subjected to hostile bid. Investigative media and the threat of litigation added to the pressure on directors. The directors of American Express, General Motors, and IBM all had cause to regret the power of institutional fund managers to vote their shares against incumbent members of boards whom they considered to be performing badly.

The US Treadway Commission had been formed in 1985 to consider fraudulent corporate financial reporting. Its first report (1987) led to the creation of the Committee of Sponsoring Organizations of the Treadway Commission (COSO)⁶, a private-sector initiative to encourage executive management and boards towards more effective business activities.

Developments in the 1990s: corporate governance codes arrive

In the 1990s, corporate governance codes arrived. The first was the UK's Cadbury Report (1992), produced by a committee chaired by Sir Adrian Cadbury, on the financial aspects of corporate governance. Based on what was considered good practice, the code called for:

- the wider use of independent non-executive directors, with 'independence' defined as 'independent of management and free from any business or other relationship which could materially interfere with the exercise of independent judgement, apart from their fees and shareholding';
- the introduction of an audit committee of the board with independent members;
- the division of responsibilities between the chairman of the board and the chief executive, or, if the roles were combined, strong independent directors;
- the use of a remuneration committee of the board to oversee executive rewards;
- the introduction of a nomination committee with independent directors to propose new board members;
- reporting publicly that the corporate governance code had been complied with or, if not, explaining why.

⁶ Originally formed to sponsor the National Commission on Fraudulent Financial Reporting, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission is a voluntary private-sector organization dedicated to guiding executive management and governance participants towards the establishment of more effective, efficient, and ethical business operations on a global basis. It sponsors and disseminates frameworks and guidance based on in-depth research, analysis, and best practices. The following organizations take part:

The American Accounting Association;
 The Institute of Management Accountants;
 The American Institute of Certified Public Accountants;
 The Institute of Internal Auditors; and
 The Financial Executives International.

Some critics of the Cadbury Report argued that it went too far—the emphasis on the importance of non-executive directors would introduce the controls of the European two-tier supervisory board by the back door, they said. Others felt that the report did not go far enough—it lacked teeth by proposing delisting rather than legally enforceable sanctions.

In the United States, companies must follow the company law of the state in which they are incorporated, and comply with US generally accepted accounting principles (GAAP). In addition, companies must meet the demands of the Securities and Exchange Commission (SEC), and the rules of any stock exchange on which their shares are listed. In 1997, the US Business Roundtable, which takes a pro-business perspective, produced a Statement on Corporate Governance, which was updated in 2002, listing the following guiding principles of sound corporate governance.

- The paramount duty of the board of directors of a public corporation is to select a chief executive officer and to oversee the CEO and other senior management in the competent and ethical operation of the corporation on a day-to-day basis.
- It is the responsibility of management to operate the corporation in an effective and ethical manner in order to produce value for stockholders.
- It is the responsibility of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition and results of operations of the corporation.
- It is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on GAAP.
- It is the responsibility of the independent accounting firm to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with generally accepted auditing standards (GAAS).
- The corporation has a responsibility to deal with its employees in a fair and equitable manner.

But corporate governance in the United States tends to be based on mandatory compliance with regulation and law,⁷ rather than the discretionary ‘comply or explain’ approach of codes elsewhere.

The Cadbury Report became significant in influencing thinking around the world. Other countries followed with their own reports on corporate governance. These included the Viénot Report (1995) from France, the King Report (1995) from South Africa, the Toronto Stock Exchange recommendations on Canadian Board practices (1995), the Netherlands Report (1997), and a report on corporate governance from the Hong Kong Society of Accountants (1996).⁸ As with the Cadbury Committee Report (1992), these reports were particularly concerned about the potential for abuse of corporate power. Similarly, they called for greater conformance and compliance at board level, recommending the use of audit committees as a bridge between board and external auditor, the wider use of independent outside, non-executive directors,

⁷ This was reinforced by the 2002 post-Enron Sarbanes-Oxley Act.

⁸ We will study these codes in detail in Chapter 5.

and the separation of the role of chairman of the board from that of chief executive. More checks and balances to avoid executive domination of decision-making and to protect the rights of shareholders, particularly minority shareholders, was the theme.

An Australian Committee on Corporate Governance (1993), chaired by Professor Fred Hilmer of the Australian Graduate School of Management, however, advanced a view that added a new dimension to the conformance and compliance emphasis of the Cadbury and the other reports. Governance is about performance as well as conformance, the report argued: 'The board's key role is to ensure that corporate management is continuously and effectively striving for above-average performance, taking account of risk.' It adds, almost as an afterthought, 'this is not to deny the board's additional role with respect to shareholder protection'.

The committee gave its report the splendid title *Strictly Boardroom*—after the film *Strictly Ballroom*, which portrays the world of competitive ballroom dancing, in which originality, creativity, and innovation had been sacrificed to inflexible and inhibiting rules and regulations. This is the danger facing current governance practices, argued Hilmer, with conformance and compliance overshadowing improved corporate performance.

In 1998, the Organisation for Economic Co-operation and Development (OECD) proposed the development of global guidelines on corporate governance and encouraged states to introduce such corporate governance guidelines. The report usefully emphasized the contrast between the strong external investment and firm corporate governance practices in America and Britain and those in Japan, France and Germany, which had less-demanding governance requirements. In these countries, other constituencies, such as employees, receive more deference, the regulatory structures are less obtrusive, directors are seldom truly independent, and investors seem prepared to take a longer-term view. Some dismissed the proposals as 'pointless'; others saw merit in establishing some core principles of good corporate governance. Then, the Commonwealth countries also produced a code of principles of good corporate governance, which made recommendations on good corporate governance practice at the level of the company.

In the US, Institutional Shareholder Services and the Investor Responsibility Research Center, emerged to inform institutional fund managers on governance issues. In the UK, the Association of British Insurers and the National Association of Pension Funds also actively advised their members on proxy voting issues. In Australia, it was the Australian Investment Managers' Association. The Californian State Employees Pension Fund (CalPers) was particularly active, producing global principles for corporate governance, intended to benchmark corporate governance practices in companies in its portfolio around the world. In response, some companies, such as General Motors (1996), published their own board governance guidelines on significant governance issues.

However, probably the most telling driver of change in corporate governance in the 1990s was the dynamic, flexible new corporate structures, often global, that were now replacing the stable, often regional, corporate groups of the post-war years—massively complex networks of subsidiary companies and strategic alliances with cross-holdings of shares, cross-directorships, chains of leveraged funding, and dynamic and ever-changing operational and financial linkages throughout the added-value chain. These were networks that operated in multiple jurisdictions, cultures, and currencies—groupings with voracious appetites for growth. Top management of major corporations around the world was now wielding enormous power.

While claiming to reflect owners' interests, directors were seen to be pursuing their own agendas and expecting huge rewards—privileges reserved in earlier generations for kings and courtiers.

Developments early in the 21st century: reactions to more corporate collapses

As the 21st century dawned, corporate governance seemed to be developing well around the world. Codes of principles or best practice in corporate governance for listed companies were in place in most countries with stock markets. The importance of good corporate governance was well recognized. Many of the corporate governance codes now called for director appraisal, training, and development, and for board-level performance reviews. Many felt that markets were offering a premium for shares in well-governed companies. This was particularly the case in the United States. Indeed, there was a widespread expectation in the US that the rest of the world would gradually converge with the American approach to corporate governance and the US GAAP, not least because the world, it was felt, needed access to American funds.

But the new century had scarcely begun when disaster struck. Enron, one of the largest companies in the US, collapsed on the back of heavy, unreported indebtedness and dubious corporate governance attitudes among the executive directors. Enron,⁹ Waste Management, Worldcom, and Tyco in the United States, as well as Arthur Andersen, one of the big five global accounting firms, which was the auditor of Enron, Worldcom, and Waste Management, collapsed as clients changed auditors and partners changed firms. Corporate governance problems appeared in companies in other parts of the world. In the UK, Marconi, British Rail, Independent Insurance, and Tomkins faced governance problems, as did HIH Insurance in Australia, Parmalat in Italy, and Vodafone Mannesmann in Germany.

The US GAAP were now pilloried as being based on rules that could be manipulated, rather than on the principles of overall fairness required in international accounting standards. Financial transparency, governance processes, and, most significantly, attitudes toward corporate governance in other companies were questioned. Confidence in the financial markets was shaken. Suddenly, from being the leaders of economic success, entrepreneurial risk-taking, and sound corporate governance, directors were depicted as greedy, short-sighted, and more interested in their personal wealth and share options than in creating sustainable wealth for the benefit of the shareholders. The response was more legislation.

In 2001, in the United States, a Blue Ribbon Commission, set up by the National Association of Corporate Directors (NACD), published a report *Director Professionalism*, the key recommendations of which were as follows.

- Boards should be composed of a substantial majority of independent directors.
- Boards should require that key committees—including, but not limited to, audit, compensation, and governance/nominating—be composed entirely of independent directors, and be free to hire independent advisers as necessary.

⁹ The Enron case has become a classic and is summarized in Appendix 2.

- Each key committee should have a board-approved written charter detailing its duties. Audit committee duties, at a minimum, should include two key elements:
 - a. oversight of the quality and integrity of financial reports and the process that produces them; and
 - b. oversight of the management of risk.

Compensation committee duties should include performance goals that align the pay of managers with the long-term interests of shareholders. Governance/nominating committee duties should include setting board and committee performance goals and nominating directors and committee members with the qualifications and time to meet these goals.

- Boards should consider formally designating an independent director as chairman or lead director.
- Boards should regularly and formally evaluate the performance of the CEO, other senior managers, the board as a whole, and individual directors. Independent directors should control the methods and criteria for this evaluation.
- Boards should review the adequacy of their companies' compliance and reporting systems at least annually. In particular, boards should ensure that management pays strict attention to ethical behaviour and compliance with laws and regulations, approved auditing and accounting principles, and with internal governing documents.
- Boards should adopt a policy of holding periodic sessions of independent directors only. These meetings should provide board and committee members the opportunity to react to management proposals and/or actions in an environment free from formal or informal constraints.
- Audit committees should meet independently with both the internal and independent auditors.
- Boards should be constructively engaged with management to ensure the appropriate development, execution, monitoring, and modification of their companies' strategies. The nature and extent of the board's involvement in strategy will depend on the particular circumstances of the company and the industry or industries in which it is operating.
- Boards should provide new directors with a director orientation programme to familiarize them with their company's business, industry trends, and recommended governance practices. Boards should also ensure that directors are continually updated on these matters.

A year later, the American Law Institute published a set of general principles on corporate governance, which generated a debate on the regulation of boards and directors. In November 2003, the SEC approved new listing requirements reflecting many of the NACD's recommendations.

In 2002, the US Sarbanes-Oxley Act, which we will explore in detail later, was rushed through, placing new stringent demands for the governance of all companies listed in the

United States. This Act, now nicknamed 'SOX' or 'Sarbox', significantly raised the requirements and the costs of corporate governance. The New York Stock Exchange and Nasdaq reflected the changes in their listing rules. Only independent directors could now serve on audit and remuneration committees, shareholders had to approve plans for directors' stock options, and subsidized loans to directors were forbidden. A new institution was created to oversee audit firms, which must rotate their audit partners, to prevent an overfamiliarity between auditor and the client's finance staff. Auditors were also forbidden to sell some non-audit services to audit clients, and audit staff were to serve a cooling-off period before joining the staff of an audit client—all of which had happened in Enron (see Appendix 2).



Case study 1.1 Robert Maxwell

Robert Maxwell, then Jan Ludvik Hoch, was born in Czechoslovakia in 1923, grew up in poverty, fought with the Free Czech army in the Second World War, and received the British Military Cross. He became an international publishing baron. In the early 1970s, inspectors appointed by the UK government led an inquiry into the failure of his company Pergamon Press and concluded that he was not 'a person who can be relied on to exercise stewardship of a publicly-quoted company'. Nevertheless, he subsequently succeeded in building a media empire including two public companies—Maxwell Communication Corporation and Mirror Group Newspapers. Following his death in 1991, in mysterious circumstances at sea, it was alleged that he had used his dominant position as chairman of the trustees of the group's pension funds to siphon off funds to support his other interests and that he had been involved in an illegal scheme to bolster the price of companies in the group. Eventually, the lead companies were declared insolvent, banks called in loans that could not be repaid, and the group collapsed. Investigators estimated that £763 million had been plundered from the two public companies and their pension funds to prop up Maxwell's private interests.

There are many lessons for directors in the Maxwell affair. Maxwell's leadership style was dominant: he reserved considerable power for himself and kept his top executives in the dark. An impressive set of non-executive directors added respectability to the public company boards, but they were ill-informed. Maxwell threatened litigation to prevent criticism of his corporate affairs: many investigative journalists and one doctoral student received writs. The complexity of the group's organizational network, which included private companies incorporated in tax havens with limited disclosure requirements, made it difficult to obtain a comprehensive overview of group affairs. The auditors were criticized. In a revealing internal memo, the senior partner of CoopersLybrandDeloitte wrote: 'The first requirement is to continue to be at the beck and call of Robert Maxwell, his sons, and his staff, appear when wanted, and provide whatever is required' (discovered by Persaud and Plender, 2006). The failings of the trustees of the Maxwell group pension fund and the regulatory bodies were all recognized.

Involvement with his father's empire left Robert Maxwell's son Kevin bankrupt. Two decades later, in 2011, Kevin Maxwell was disqualified as a director for eight years by the UK Department for Business Innovation and Skills. According to its findings, he and two other directors had diverted more than £2 million out of the bankrupt construction company Syncro Ltd ahead of liquidation. He had also failed to preserve accurate records in a 'disregard for a director's duty'.

(continued)

Discussion questions

1. Research information about Robert Maxwell (try Google or Bing).
2. What accounts for his enormous success and subsequent failure?
3. What corporate governance lessons can be learned from the Maxwell case?

Towards the end of the 20th century, the main emphasis in the field of corporate governance had been on listed companies. But a parallel development had occurred during the 1990s, accelerating into the 2000s: the concepts and principles of corporate governance developed for listed companies were also seen to be relevant to unlisted private companies and to many other corporate entities. Corporate governance policies and procedures were developed for charities, educational, sports and medical bodies, professional institutions, government corporations, and quangos.¹⁰ In some cases, corporate governance codes and best governance practices were published.

Corporate governance implications of the global financial crisis

In 2007, in the United States, after more than a decade of substantial growth, house prices began to fall, leaving some owners in negative equity, their mortgage loans greater than the value of their homes. Worse, it emerged that many of these loans had been made to people who were not good credit risks—the so-called sub-prime market. Foreclosures escalated, driving house prices down further. But for a decade, lax monetary policies, cheap money, and massive liquidity had produced a lending-and-asset bubble in the Western world. Companies used low-interest loans to leverage their financial strategies. World trade boomed, with some countries facing vast trade imbalances. Personal borrowing soared: some secured on inflating house prices; some on extended credit card debt.

The catalyst for the subsequent chaos was financial engineering. Financial institutions had bundled their loan assets into securities, which they then sold on to other financial institutions. This securitization of debt spread the risk around the world's financial systems, but, because these instruments were complex and sophisticated, there were problems matching exposure to security. Moreover, not all bank directors appreciated the extent of their banks' exposure to risk. Rumours of banks overexposure to sub-prime debt circulated, lowering confidence, which is the basis of every financial system: confidence that credit will be available when needed and trust that debts will be repaid when due. Facing uncertainty, banks began to tighten their lending policies. Funds became scarce. Central banks had to make special arrangements to provide money to meet some institutions' liabilities.

¹⁰ Quasi-autonomous non-governmental organizations.

In 2007, the first run on a UK bank for over a century occurred at the Northern Rock bank,¹¹ which was taken over by the British government. In the US, Bear Stearns, a financial institution, was bailed out by the US government. Then, dramatically, the two huge American mortgage organizations, Fannie Mae and Freddie Mac, which account for a large part of all mortgages to homeowners in the United States, were given government guarantees of up to US\$5 trillion. Next, American International Group (AIG), the world's biggest insurer and provider of hedging cover to the banking system, imploded. The US government, believing that it could not countenance the adverse economic effects of an AIG failure, provided a loan facility of US \$85 billion to protect the interests of its taxpayers, secured on assets of AIG, taking an 80% equity stake in the company. Lehman Brothers was not so fortunate: the Federal Reserve System refused to support it and, after 158 years, the firm became bankrupt. In retrospect, it was a questionable decision because it drove down market confidence still further.

In September 2008, the US Federal Reserve and the US Treasury tried to restore confidence. They proposed a bailout in which the American government would take on banks' bad debts, including the sub-prime loans, with the underlying collateral security. Some complained that this would allow the financial executives, whose reckless investments had caused the crisis in the first place, to unload their risky assets and then walk away with their bonuses and golden parachutes intact.

Other countries around the world also experienced liquidity problems. In September 2008, there was a run on the Bank of East Asia in Hong Kong, which was quickly met by reassurances from Hong Kong's financial authorities. In October 2008, all of the banks and the stock exchange in Iceland were closed when depositors' demands for cash could not be met. Iceland, a country of around 300,000 people, which had previously relied on fishing and tourism, had been led by a handful of financial entrepreneurs to engage in international finance way beyond its economic potential.

In the United States, plans were announced for the government to take a US\$700 billion equity stakes in its banks. In the UK, the government effectively nationalized three banks—Royal Bank of Scotland, HBOS, and Lloyds TSB. Some bank bosses lost their jobs. In both the United States and the UK, the government had now become the largest provider of mortgages. Iceland, meanwhile, its banks and stock exchange still closed and its currency untradable, appealed to the International Monetary Fund for help.

The global financial crisis raised some fundamental corporate governance issues.

- Where were the directors of the failed financial institutions—particularly the independent outside directors who were supposed to provide a check on overenthusiastic executive directors? Did they really understand the strategic business models and sophisticated securitized instruments involved? In other words, did they appreciate the risk inherent in their companies' strategic profile?
- Where were the banking regulators? Although the extent of the crisis was unprecedented, the regulators seem to have been beguiled into complacency, perhaps taken over by the industry they were there to regulate. New rules followed.

¹¹ We will study the Northern Rock case in Chapter 8.

- Where were the auditors? In approving the accounts of client financial institutions, did they fully appreciate and ensure the reporting of exposure to risk?
- Did the credit agencies contribute to the problem by awarding high credit ratings to companies overexposed to significant risk?
- Government bailouts also raised the question of so-called moral hazard—by protecting bankers from their past reckless decisions, would others be encouraged to take excessive risks in the future?
- Will the experts who designed the sophisticated loan securitization vehicles and other financial engineering systems be held to account? Are their ideas and enthusiasms now under control?
- Were any of the financial institutions' activities illegal? Compare the situation with Enron, in which some top executives continued to believe that nothing they had done was illegal, even after they were in jail.
- Finally, did excessive bonuses and share options encourage short-term and unrealistic risk-taking with shareholders funds? The news that some bankers had lost their fortunes as share prices collapsed was cold comfort to mortgagees who lost their homes, shareholders who lost their savings, and employees who lost their livelihoods.

Predictably, regulatory authorities sought to improve corporate regulation to avoid further problems. In the United States, the Securities and Exchange Commission proposed changes to regulatory procedures for listed companies including obligatory (although non-binding) shareholder votes on top executive remuneration, the annual election of directors, and the creation of board-level committees to focus on enterprise risk exposure. The separation of the CEO role from that of the board chairman, as called for in corporate governance codes in other countries, was suggested.

In the United Kingdom, although the Financial Review Council did not find evidence of serious failings in the governance of British businesses outside the banking sector, it did propose changes to the UK Code to improve governance in major businesses. The proposed changes were intended to enhance accountability to shareholders, to ensure that boards are well balanced and challenging, to improve a board's performance and to deepen awareness of its strengths and weaknesses, to strengthen risk management, and to emphasize that performance-related pay should be aligned with the company's long-term interests and risk policy.

In 2010, the existing UK Combined Code was renamed the UK Corporate Governance Code,¹² a name some thought might have been more appropriate all along. The main proposals for change were:

- annual re-election of chairman or the whole board;
- new principles on the leadership of the chairman, and the roles, skills, and independence of non-executive directors and their level of time commitment;
- board evaluation reviews to be externally facilitated at least every three years;

¹² *Proposed Reforms to the UK Corporate Governance Code* (2009) FRC PN 287, 1 December. Available at: www.frc.org.uk/corporate/reviewCombined.cfm

- regular personal performance and development reviews by the chairman with each director;
- new principles on the board's responsibility for risk management;
- performance-related pay should be aligned to the company's long-term interests and its risk policy;
- companies to report on their business model and overall financial strategy.

The corporate governance principles published by the OECD were designed to assist countries to develop their own corporate governance codes.¹³ The OECD's Steering Group on Corporate Governance re-examined the adequacy of these principles in light of the global economic problems. The real need, it felt, was to improve the practice of the existing principles. In two seminal papers,¹⁴ four broad areas were identified as needing attention: board practices; risk management; top-level remuneration; and shareholder rights.

New frontiers for corporate governance

Corporate governance thinking and practice continue to evolve. We will be exploring these new frontiers throughout this book, but for now let us consider some of the more significant of these.

Growing corporate complexity

Research from the Harvard Business School,¹⁵ following the global financial crisis, concluded that recent boardroom failures differed from the previous corporate failings, such as Enron, WorldCom, and other corporate collapses, which were rooted in management malfeasance and led to the US Sarbanes-Oxley Act. However, recent corporate governance problems, the researchers found, were primarily attributable to the growing complexity of the companies that boards governed. The research found a strong consensus among directors that the key to improving boards' performance was not government action, but action by each board. Moreover, it emphasized the differences between companies and concluded that each board needed to develop structures, processes, and practices to fit its needs. The notion that 'one size fits all' was viewed with scepticism. The Harvard research identified six areas for improvement at board level:

- clarifying the board's role;
- acquiring better information and deeper understanding of the company;

¹³ OECD (2004) *Principles of Corporate Governance*. Available at: www.oecd.org/daf/corporateaffairs/principles/text

¹⁴ Grant Kirkpatrick (2009) *The Corporate Governance Lessons from the Financial Crisis*. February. Also, *Corporate Governance and the Financial Crisis: Key Findings and Main Messages*. June 2009. Both publications are available at www.oecd.org

¹⁵ *Perspectives from the Boardroom* (2009) Jay Lorsch with Joe Bower, Clayton Rose, and Suraj Sriinivasan, Harvard Business School, Cambridge, MA, USA.

- maintaining a sound relationship with management;
- providing oversight of company strategy;
- assuring management development and succession;
- improving risk management.

Changes in ownership patterns

In the early days of the corporate concept, the shareholding owners of the company were just one removed from the board of directors they elected to run their company. This can still be the case in small and start-up companies. But elsewhere the situation has become strikingly different. A complex chain of intermediaries and agents can lie between investors and the company in which they are ultimately investing. For example, an individual might invest in a pension fund, which invests in a highly geared hedge fund, which invests in an index-tracking fund, which invests in the shares on a given stock market index. Moreover, shares in the chain could be lent to cover other transactions of the financial institution involved. Consequently, it can be difficult for the ultimate owner to exercise any influence over the governance of the company in which his or her funds have been invested, which was the original intention of the corporate concept. Further, private equity deals, in which financial institutions take listed companies often with highly leveraged financial positions, have added to corporate governance issues, particularly accountability and transparency.

Board responsibility for enterprise risk management and business continuity

Companies add value in different ways to achieve their corporate goals. In some businesses, added value lies in the global upstream supply chain; in others, in their technological expertise, brand image, or dominant market position; in others, in the downstream distribution network, in access to finance, managerial expertise, or reputation. Failure in a critical area can expose a company to strategic risk and even threaten business continuity. Consider the case of the catastrophe at BP's Deepwater Horizon oil rig.¹⁶

Surprisingly, studies have shown that some outside directors do not know where value is added in their company. Consequently, they cannot know where the company is exposed to strategic risk. So the most significant risks that companies face may be the least well understood by boards. In the global financial crisis, it was apparent that many directors of financial institutions did not understand their firms' exposure to strategic risk.

Directors need to understand how value is added within their business, where the company is critically exposed to risk, and what policies are in place to manage those risks. Identifying and assessing critical risk needs to be a board-level activity. The handling of operational and managerial risk can be delegated to management, with the board ensuring that the enterprise risk management policies and systems are working. But decisions about risks at the strategic level should not be delegated. They are fundamentally part of the board's responsibility for formulating strategy. Corporate governance involves creating business value while

¹⁶ The case of the BP Deepwater disaster appears in Chapter 8.

managing risk. Of course, senior management plays an important part in the process, but the responsibility ultimately belongs to the board.

Should corporate governance be by rule or principle

Many commentators have referred to the 'Anglo-American' approach to corporate governance. They contrast the Anglo-American governance traditions of the unitary board, with both executive and non-executive directors, against the continental European two-tier, supervisory and executive boards. They compare the company law approach of the Anglo-American common law jurisdictions with that of civil law countries. But actually a schism has appeared between American and British concepts of corporate governance: the former is built on a prescriptive rules-based legal approach to governance; the latter prefers a non-prescriptive, principles-based, more self-regulatory approach.

The underpinning of American corporate governance has become mandatory governance determined by regulation and law, such as the SOX Act. In other words, 'obey the legal requirements or risk the penalties', which can include unlimited fines and jail. China is following a similar legal orientation. By contrast, the basis of corporate governance in Britain and other countries,¹⁷ the company law of which has been influenced over the years by UK common law traditions, involves a discretionary approach to governance by principle. In other words, 'comply with the code or explain why you have not'. This frontier is really a fundamental philosophical debate of considerable significance for the future of the subject. The European Union is again reviewing the basis of corporate governance in member states and may opt for the more rule-orientated continental European model of company law. The dilemma remains unresolved.

Boards marking their own exam papers

Another dilemma concerns the workings of the unitary board, in which directors are responsible for both the strategic direction of the business and overseeing the activities of executive management. In other words, the board is expected to be involved in strategy formulation and planning while also supervising management performance. It has been suggested that this means the unitary board is effectively trying to mark its own examination papers. Of course, the two-tier board structure avoids this problem by having the executive board responsible for performance and the supervisory board for ensuring conformance, common membership between the two boards being forbidden.

To overcome this dilemma, corporate governance codes call for independent outside (non-executive) directors to play a vital role. Independence is precisely defined to ensure that these directors have no interest in the company that might, or might be seen to, adversely affect genuine independent and objective judgement. The minimum number or percentage of independent board members is usually specified. The definition of independence in most corporate governance codes is typically exhaustive. To be considered independent, a director must have no relationship with any firm in the upstream or downstream added-value chains,

¹⁷ Including Australia, Canada, New Zealand, Hong Kong, India, Malaysia, South Africa, Singapore, and Hong Kong.

must not have previously been an employee of the company, nor must he or she be a nominee for a shareholder or any other supplier of finance to the company. Indeed, the definition of independence is so strict that an independent director who has served on the board for a long period is often assumed to have become close to the company and is no longer considered independent. But this can create another dilemma.

Independent directors who do not know enough about the business

The more independent directors are, the less likely they are to know about the company and its industry. The more non-executive directors know about a company's business, organization, strategies, markets, competitors, and technologies, the less independent they may become. Yet the knowledge and experience of such people are exactly what top management needs to contribute to its strategy, policymaking, and risk assessment.

The New York Stock Exchange (NYSE) sponsored a Commission that published ten core principles of corporate governance.¹⁸ While the Commission supported the NYSE's listing requirements, which call for a majority of independent directors, it also pointed out that companies can have additional non-independent outside directors so that there is an appropriate range and mix of expertise, diversity, and knowledge. The Commission pointed out that while independence is an important attribute for board members, the NYSE's Listing Standards do not limit a board to just one non-independent director, and boards should seek an appropriate balance between independent and non-independent directors.

The ten core principles were as follows.

1. The Board's fundamental objective should be to build long-term sustainable growth in shareholder value for the corporation.
2. Successful corporate governance depends upon successful management of the company, because management has the primary responsibility for creating a culture of performance with integrity and ethical behaviour.
3. Good corporate governance should be integrated with the company's business strategy and not viewed as simply a compliance obligation.
4. Shareholders have a responsibility and long-term economic interest to vote their shares in a reasoned and responsible manner, and should engage in a dialogue with companies in a thoughtful manner.
5. While legislation and agency rule-making are important to establish the basic tenets of corporate governance, corporate governance issues are generally best solved through collaboration and market-based reforms.
6. A critical component of good governance is transparency, because well-governed companies should ensure that they have appropriate disclosure policies, and practices, and investors should also be held to appropriate levels of transparency, including disclosure of derivative or other security ownership on a timely basis.

¹⁸ New York Stock Exchange: Sponsored Commission on Corporate Governance, 10 Core Principles of Corporate Governance, October 2010—a commission representing investors, issuers, broker-dealers, and governance experts.

7. The Commission supports the NYSE's listing requirements generally providing for a majority of independent directors, but also believes that companies can have additional non-independent directors so that there is an appropriate range and mix of expertise, diversity, and knowledge on the board.
8. The Commission recognizes the influence that proxy advisory firms have on the markets, and believes that it is important that such firms be held to appropriate standards of transparency and accountability.
9. The SEC should work with exchanges to ease the burden of proxy voting, while encouraging greater participation by individual investors in the proxy voting process.
10. The SEC and/or the NYSE should periodically assess the impact of major governance reforms to determine if these reforms are achieving their goals.

Members' changing expectations of directors and boards

Once upon a time, a directorship was a sinecure—an occasional meeting between friends, maybe a few supportive questions, then a fee and probably lunch. Not now. Today, more is expected of company directors, indeed of the members of all governing bodies, than ever before. In listed companies, shareholders are no longer compliant. They expect their directors to increase shareholder value, but not at the price of accounting distortions, excessive director remuneration, or misleading financial disclosure. Institutional investors in these companies—the insurance companies, pension funds, and financial institutions—put pressure on poorly performing boards, complain publicly about allegedly excessive directors' remuneration, and demand high standards of corporate governance. The requirements on listed companies and their directors, from financial regulators, stock exchanges, and an increasingly investigative media around the world, have also increased. The threat of litigation against companies, boards, and individual directors has introduced the risk of serious financial exposure as well as the potential for public derision.

Directors of private companies—that is, those without public investors, such as entrepreneurial businesses, subsidiary companies, joint venture entities, and family firms—can also find themselves under the corporate governance spotlight. The interests of minority shareholders must be protected. In certain circumstances, directors can become personally responsible for their company's debts. They can also be fined heavily if the company fails to meet its statutory obligations. Moreover, like their public company counterparts, shareholders in private companies now expect their directors to set high standards of governance and to deliver improving corporate performance.

Members of the governing bodies of not-for-profit institutions, including hospital trusts, charities, professional bodies, cooperatives, colleges, and community organizations, also face demands for better governance. Members of their governing bodies are expected to act professionally, and be accountable, with their activities transparent.

Society's changing expectations of directors and boards

Society's expectations of companies, boards, and directors are changing, too. The movement we saw in the 1970s, expecting more of companies than just making a profit for their shareholders while remaining within the law, has reappeared with new force. Company collapses in the late 20th and early 21st centuries and growing criticism of directors' behaviour, reinforced

by the trauma caused by the global financial crisis, have led to renewed concern about business ethics. The original 19th-century concept of the limited-liability company was founded on trust and stewardship. But the ethical framework enshrined in the original concept has been overshadowed as power shifted from owners to directors. Now pressures for sound governance, director-level stewardship, and ethical business behaviour are emerging.

In a world affected by global finance, trading, and services, the need for socially responsible behaviour by companies has acquired new momentum. Calls have increased for companies to show concern for the effects of their actions on all stakeholders including the communities they affect. Corporate social responsibility, or CSR as it is now widely known, has become a major concern of many companies, as we shall see. The concern for ecology and the conservation of the planet's resources, taking corporate decisions that do not deplete the world's resources to the detriment of future generations, has brought sustainable development to the corporate governance agenda. Corporate governance has acquired some new dimensions.

Cultural considerations affect corporate governance

As we saw earlier in this chapter, significant developments in corporate governance have come from the unitary board countries, principally the United States and the UK, while continental European countries provide a counterpoint with their two-tier boards. But, subsequently, some unique aspects in other countries that affect the way in which corporate governance develops have become apparent. For example, the way in which business is done, the extent to which legal contracts or interpersonal trust form the basis for business decisions, the sources of capital, the legal traditions, the state of company law, the reliability of the courts, the existence of relevant institutions, the standing of the accountancy, audit, and legal professions, the powers of the regulatory authorities, and overall the traditions of the country and the expectations of its people, all influence the way in which corporate governance develops. Later, we will explore the relevance of culture to corporate governance, reviewing governance in Brazil, China, India, Japan, Russia, countries in which Islamic *sharia* law affects governance, and those in which the traditional Chinese-led family business dominate.

As the book now unfolds, these frontiers will be explored in depth.



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Useful websites

www.corpgov.net A valuable site, full of vital corporate governance information by company, country, and topic, reviews, updates, and library, plus vital links to other relevant corporate governance sites.



Projects and exercises

1. Prepare a report on why the underlying ideas and concepts of corporate governance were slow to evolve. Why was the phrase 'corporate governance' not used until the 1980s and the subject scarcely studied during the later half of the 20th century when the study of management was at its height?
2. Research one or more of the cases of early corporate collapses mentioned in the text: in Australia, Alan Bond, Laurie Connell of Rothwells, and the Girvan Corporation; in Japan, Nomura Securities and the Recruit Corporation; in the United States, Ivan Boesky, Michael Levine, and Michael Milken of Drexel, Burnham, and Lambert; in the UK, Guinness and the Robert Maxwell companies. Prepare a report or class presentation outlining the case(s). What was the underlying reason for the failure? Would today's corporate governance codes, rules, and regulations have prevented these outcomes?
3. Explore the cases of recent corporate collapse mentioned in the text (Enron, Waste Management, Worldcom, and Tyco in the United States; Marconi, British Rail, Independent Insurance, and Tomkins in the UK; HIH Insurance in Australia; Parmalat in Italy; and Vodafone Mannesmann in Germany). Is there an underlying explanation for their failure?
4. Explore the collapse of financial institutions mentioned in the chapter. Prepare a report or a class presentation on corporate governance implications stemming from the global financial crisis.



Self-test questions

To confirm your grasp of the key points in this chapter, try answering the following questions.

1. Define corporate governance.
2. What are the main attributes of the limited-liability company?
3. What is the basis of corporate power?
4. What did the classical Berle and Means (1932) study emphasize?
5. What was the response of the UK Bullock Committee Report (1977)?
6. What did the Corporate Report (1975) from the UK Accounting Standards Committee propose?
7. Name some corporate collapses in the 1980s that led to the first studies of corporate governance.
8. What was the first official report on corporate governance and why was it commissioned? What were the major recommendations of the Cadbury Report?
9. Name some financial institutions in the US that failed during the global financial crisis.
10. What additional dimension did the Australian Hilmer Report add to the conformance and compliance concepts of corporate governance?