Effective Corporate Governance

July 2011
Financial Reporting Council

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Executive Summary

The productive capacity of most economies in the world depend on the sustainable creation of value by companies – over 70% of world trade is controlled by just 500 companies. How these companies are run is therefore of fundamental importance to economic efficiency, stability and growth.

Given its significance, it is understandable to observe real public interest in corporate governance and considerable value in getting things right. The latter requires an evidence based approach to policymaking – one backed by theoretical and empirical findings. Whilst academic research has provided valuable insight into the value of corporate governance, it has not identified the perfect framework for improving corporate governance. This is not surprising. In Europe the diversity of legal systems, ownership structures and other factors mean that there is no single set of rules, framework or plan to achieve good corporate governance. Flexibility of policy across economies is therefore desirable.

The objective of this paper is to identify the essential components for promoting corporate governance. These components include regulation - where necessary - to establish basic standards of conduct and transparency - codes to encourage best practice, and shareholder rights as well as responsibilities to promote accountability. It also identifies the key benefits of codes.

The paper provides arguments in favour of proportionality, flexibility and targeting – all features inherent in a system where best practice is encouraged through codes. The paper argues that codes:

1. are effective in changing behaviour
2. are adaptive to the needs of companies
3. can be more effective at raising standards than law
4. evolve easily over time in response to changing economic circumstances
5. reduce the risk of moral hazard
6. help standards of corporate governance converge between countries
7. incentivise innovation and encourage thought leadership
8. are less costly than law

Corporate governance must be informed by theoretical and empirical evidence so that it may lead to the efficiency, stability and growth desired. The FRC hopes that this paper contributes to this debate.
Contents

One - Introduction .................................................................................................................. 5

Two - The components of a corporate governance framework ................................. 8

- Shareholder rights and responsibilities. ................................................................. 8
- Accurate and relevant information ........................................................................ 10
- Company behaviour ............................................................................................. 10

Three - Features of codes that encourage best practice in corporate governance and change behaviour ................................................................. 12

Four - Conclusion ........................................................................................................... 18
One - Introduction

“The proper governance of companies will become as crucial to the world economy as the proper governing of countries”

*James D. Wolfensohn, President of the World Bank, 1999*

Good corporate governance supports the sustainable performance of companies and in doing so supports the global economy – Mr Wolfenshohn’s prediction in 1999 has come to pass. This is evident from the growth of large corporations and their prominence in global economic activity – as these companies grow, their economic footprint and the quality of their governance systems has wider economic consequences:

- Of the 100 largest economies in the world, 52 are companies.
- Over 70% of world trade is controlled by just 500 companies.
- In 2002, almost a third of world output came from 200 companies.

At the London Stock Exchange (LSE, 2009), combined market capitalisation was £3.7 trillion in 2010 or 112% of UK GDP in that year. Over £21 billion was raised through London’s exchange in 2010 and £366 billion over the last 10 years.

Confidence in corporate governance is integral to confidence in capital markets and to the cost of capital. During the recent financial crisis, capital markets played an important part in supporting the UK economy, despite high levels of macro-economic risk and uncertainty. As GDP in the UK fell during 2008 and 2009, companies on the FTSE were able to shore up their balance sheets through the sale of corporate bonds, equity and commercial paper (Chart 1). The effects of the recession could have been much deeper had these companies been unable to raise capital in the way they did.

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1 Data available at: [http://www.stwr.org/multinational-corporations/key-facts.html](http://www.stwr.org/multinational-corporations/key-facts.html)

2 ONS data and FRC calculations. UK GDP are at 2006 basic prices and can be found at: [http://www.statistics.gov.uk/downloads/theme_economy/Real-time-GDP-database.xls](http://www.statistics.gov.uk/downloads/theme_economy/Real-time-GDP-database.xls)
Chart 1: the contribution of capital markets to the UK economy during the recession\(^3\)

![Chart 1: UK GDP growth and Total net capital market issuance](chart.jpg)

Given the significance of corporations and their continued growth, the systems by which they will have to operate through compliance with codes and/or law will have major consequences for economic growth. The efficiency of capital markets and future trajectory of economic growth will depend on policy decisions made now.

**What is Corporate Governance?**

In this paper, corporate governance is defined using the definition from the Organisation for Economic Co-operation and Development:

> "The system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance".

An alternative answer is to think of corporate governance as a means to establish a system of control between the board and management as well as accountability from the

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\(^3\) Data for total net capital market issuance are half-yearly. Trends in Lending, Bank of England, April 2011.
board to the shareholders. This system of control and accountability facilitates long-term sustainable economic growth by aligning incentives between those who manage and those who own companies.
Two - The components of a corporate governance framework

The FRC believes that an effective corporate governance framework requires a number of components: rights to enable shareholders to hold companies to account; the availability of information needed to assess the performance and governance of companies; and an expectation of certain behaviours on the part of companies, promulgated either through law or codes. In general, the FRC believes that the law is appropriate for imposing basic standards of conduct and transparency while codes are more effective in encouraging best practice.

The following section sets out how these different components contribute to an effective corporate governance framework. The appropriate balance between them will vary from country to country. For example, the corporate governance challenges are very different in markets where shareholder ownership is highly dispersed, such as in the UK and the Netherlands, than in those where it is highly concentrated, such as in France and Germany. Flexibility in responding to these structural differences is essential.

Shareholder rights and responsibilities

Shareholders play a crucial role in holding boards to account, and so require rights which they must exercise responsibly. Prior to the recent financial crisis, the focus of governance was on the “supply side” i.e. the role of directors. Policymakers now recognise that the “demand side”, and the need to promote and remove obstacles to shareholder engagement, is at least as important.

Researchers have studied the influence of shareholders on corporate governance and have found that compliance with codes is systematically higher in firms where shareholders have appointed one or more directors and where institutional investors participate in AGMs. This is likely to be driven by one of the fundamental purposes of corporate governance (see definition), that of maintaining accountability between the board and its shareholders.

The rights and responsibilities of shareholders are defined by a varying mixture of law and code in different countries. Relative to other jurisdictions in the world, such as the US, the governance systems of the EU feature strong shareholder rights. Directive 2007/36/EC sets out a number of basic rights such as the right to information. National company law is also crucial in setting out the rights of shareholders. For example, UK law

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4 See UNCTAD 2009.
allows shareholders to call a general meeting with 5% of the share capital, and remove
the board with a majority of the votes.

The recent crisis highlighted the need for this shareholders to use their rights effectively.
The mere existence of shareholder rights will not ensure good governance. In response
to growing concern on this subject the FRC published The Stewardship Code in July
2010. This code aims to promote dialogue between company boards and investors as a
basis for improving the quality of corporate governance and long-term company
performance.

Other EU Member States have also taken action to address this issue using different
methods. For example, the Netherlands Corporate Governance Code issued in 2008
contains a number of best practice provisions which shareholders are expected to
comply with or explain why they have not. In 2010 the Portuguese securities and
insurance regulators (CMVM and ASP) issued a set of recommendations addressed to
mutual fund and pension fund managers.

The design of shareholder rights and responsibilities must take account of prevailing
ownership structures. Structural differences based on ownership could cause significant
differences in the ability of shareholders to hold boards to account.

In the UK, shareholdings in excess of 6% are rarely observed in the largest corporations.
Only 16% of the largest UK companies have a shareholder with more than a 25% stake,
and in just 6% of these is there a majority shareholder7. By contrast, in France and
Germany, there are much larger concentrations of ownership: in 85% of the largest
German companies and 79% of the largest French firms, there is at least one
shareholder with a stake in excess of 25% of the total. Over half the companies in both
countries, there is a single majority shareholder.

Both models have strengths and weaknesses. A more dispersed ownership structure is
likely to mean less risk of minority shareholder interests being expropriated, however, it
can also create barriers to effective organisation of shareholders in holding boards to
account. The opposite may also be true in a concentrated structure of ownership.

6 The UK Stewardship Code can be found at: http://www.frc.org.uk/corporate/investorgovernance.cfm
7 The data can be found at the CEPR web page: http://www.cepr.org/pubs/Bulletin/meets/518.htm
Accurate and relevant information

To be able to influence the performance of companies, investors must have the right information on which to base their decisions and to be effective, engagement between them and the board should be based on accurate and relevant information. Without confidence in information, capital markets would not exist.

There is evidence that poor governance increases the cost of capital⁸. Investors use information on companies’ management, strategy and risk exposure when assessing their investment risk. It therefore follows that accurate and timely information produced through good governance decreases the perception of risk and so reduces the cost of finance.

Good corporate governance also minimises information asymmetries between management and investors through the provision of standards that promote transparency and standardisation of information across industry.

The importance of information is reflected in both law and codes. National and EU legislation provide for basic rights to information which are likely to be better achieved by law. For example, Directive 2007/36/EC provides shareholders with rights to information relating to the general meeting, while Directive 2004/109/EC requires traded companies to publish an annual management report setting out, amongst other things, their key risks. Codes can build on this by setting flexible targets for sharing information which is relevant to a company’s specific context and in its shareholders’ interest.

Company behaviour

As explained, shareholder rights and the availability of accurate and relevant information are crucial for effective governance. They make up the “demand-side” of corporate governance. The “supply-side” is equally as important. This consists of standards of behaviour expected of companies. Standards are used by directors to structure their companies and processes so that they can meet corporate objectives in a sustainable and efficient way.

These standards – just as with provisions on the demand side - involve both law and codes, and the balance between the two differs between countries. For example,

requirements to disclose directors’ remuneration and allow shareholders to vote on this matter are set out in law in some EU Member States and codes in others.

Most EU Members States use a combination of company or securities law and “comply or explain” codes of best practice. The law sets the essential requirements whereas the code sets the standards regarded as best practice. This difference in objective is important. It reflects how, in many cases, the law may be less effective in setting standards of best practice. This is because codes can use broad principles such as ‘every company should be headed by an effective board’ whereas law must be more prescriptive for it to be enforceable.

Differences in expectations can also be observed in the varying corporate structures of European boards. For example, the UK is the only country in the EU with all of its listed companies governed by a unitary board⁹. The European averages for board structures are:

- Unitary – 27%
- Two-tier – 42%
- Mixed System – 31%

Rather than reflecting a ranking of quality of corporate governance, these differences are a reflection of the variety of legal provisions in Member States, as well as differences in the historical development, attitudes toward business and perceptions of what best drives economic growth. The FRC believes in the importance of diverse approaches as stated in the Report of the Reflection Group in April 2011.

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**The Benefits of Diversity Between Countries**

“The different corporate governance systems of the Union should not be viewed as an obstacle to free enterprise within a single market, but as a treasure trove of different solutions to a wide variety of challenges that has been experienced and overcome.”

*Report of the Reflection Group on the Future of EU Company Law*

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⁹ See Heidrick and Struggles, 2011.
Three - Features of codes that encourage best practice in corporate governance and change behaviour

Since the early 1990’s, governments and regulators have relied on codes to encourage the development of best practice in how businesses are organised and how they behave. This part of the paper outlines the factors that contribute to the success of codes and the arguments against replacing them with rules.

1. **Codes are effective in changing behaviour**

Codes have a proven track record in changing behaviour. For example, the first UK code, issued in 1992, recommended the separation of the chairman and chief executive. Table 1 below shows the steady increase in the percentage of firms in the FTSE 350 that separated the role of the chair and chief executive between 1995 and 2010. When the recommendation was first made, only a minority of companies were in compliance; over 95% of companies now comply. This has been achieved without recourse to law.

Table 1. Separation of the role of Chair and CEO in the UK

<table>
<thead>
<tr>
<th>Year</th>
<th>Non-executive Chair</th>
<th>Total Chair</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>82</td>
<td>173</td>
<td>47.4%</td>
</tr>
<tr>
<td>2000</td>
<td>169</td>
<td>263</td>
<td>64.3%</td>
</tr>
<tr>
<td>2005</td>
<td>247</td>
<td>313</td>
<td>78.9%</td>
</tr>
<tr>
<td>2010</td>
<td>335</td>
<td>350</td>
<td>95.8%</td>
</tr>
</tbody>
</table>

Once a code is well established, and respected, changes then can be made quickly and also lead to rapid compliance. The annual election of directors included in the UK Code for the first time in 2010, is a good example of how codes can have an immediate impact. The graph below shows the dramatic increase between 2010 and 2011. This is expected to promote the accountability of directors to shareholders and so should have material benefits in the long term performance of the company.

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10 Owen, (2006) NB – data from 2010 are taken from ‘Evolving with the Code’ Grant Thornton (2010). The two data sets between this and the other years is different, however, the benefits of including the data set are likely to outweigh discrepancies in methodology due to the strong trend observed in previous years.
**2. Codes are adaptive to the needs of companies**

Flexibility is preferable when considering corporate governance measures that may differ depending on the context and interpretation of different market participants. The governance of corporations in any advanced economy will cover numerous corporations. In the UK, the LSE covers 1,400 companies in around 40 different sectors. These companies differ in many ways – size, geographical coverage business ethos, shareholder sentiment. These differences have implications on what is required of corporate governance.

In Germany, as in other countries, there is a link between the size of the firm and the use of justifications for adopting alternative approaches – smaller companies were found to have taken more advantage of the ability to explain rather than comply than larger companies\(^\text{12}\).

Law can be adapted to vary by size too but its overall flexibility in meeting the many different dimensions of companies is limited.

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\(^{11}\) 2011 data from Addleshaw Goddard LLP. Data between 2009-2010 is from PIRC

3. **Codes can be more effective at raising standards than law**

Much of the debate over corporate governance conflates law and codes. However, they are quite different tools. Because codes are flexible and can be tailored to different contexts, standards can be higher than those set out in law, which need to be consistent and capable of being reasonably applied to all companies that are caught by them.

An example: Audit committees
The history of the formation of audit committees in the UK illustrates how codes can set and achieve higher standards.

Directive 2006/43/EC (the 8th Company Law Directive) requires all listed companies to have an audit committee (or body carrying out an equivalent function) and for at least one member to be an independent director. The Directive was issued toward the end of 2006 and it was implemented in 2008 in most Member States.

Prior to the Directive there was no legal requirement on companies in the UK to have an audit committee, although the UK code recommended audit committees in 1992. The initial recommendation was that all members should be non-executives, of which the majority should be independent. In 2003 the recommendation was changed to state that all members of the committee should be independent.

The Grant Thornton survey for corporate governance in 2006 found that 100% of FTSE 350 companies had audit committees, of which 88% were fully independent. A survey commissioned by the FRC in 2006 of 465 smaller listed companies found that 99% of them had audit committees, and 57% had fully independent committees. This compares well with the Directive’s requirement of at least a single member of the board being independent and is just one example of the effectiveness of codes.

4. **Codes evolve easily over time in response to changing economic circumstances**

Investor expectations create a powerful incentive for companies to adopt best practice. By progressively reflecting and codifying views on best practice, codes promote continuous improvement over time. Regular and open dialogue between standard setters and market participants is key to this, as is the fact that the flexibility of codes allows for a transitional period in which companies can first help develop then accept and finally adopt best practice.

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13 The survey was conducted for the FRC by Manifest. Sample calculated as follows: Those companies in the Small Cap/Fledgling indices as at the date of their AGM, where the AGM date was between 1 Sep 2005 to 31 Aug 2006. The total sample included 465 UK listed companies.
Codes are also easier and quicker to change than law. Capital markets are dynamic and innovative, providing a variety of sources of growing investment opportunities for investors. These opportunities are linked to a growing need for improved investor information, and so governance systems need to be able to adjust both in a proportionate and timely manner to be effective. In both respects, codes are useful tools as they can be used to react quickly to developments, to the emergence of new products, to new information asymmetries and to advances in governance practice. This is because codes can be redrafted and implemented without legislative change.

For example, in the Netherlands, the State Secretary for Economic Affairs established a committee to study the relationship between corporate social responsibility and corporate governance. The committee made specific recommendations which were then adopted by the code. This process began in May 2008 and was completed by the end of the year.

5. Codes reduce the risk of moral hazard

Research has found that rules may have unintended consequences whereby mandatory regulations push boards toward compliance as a box-ticking exercise and provide lesser effort toward forward-looking strategy. This creates the impression of good corporate governance when the reality may be quite different.

In a strict rules-based regulatory environment, shareholders may feel that corporate governance is being monitored effectively when it is not. Their involvement in stewardship could decline in proportion to this confidence even though regulation may be lagging behind market developments. Also, in cases where shareholders and regulators views conflict, shareholders may feel less able to influence standards as they hold relatively less power.

If companies were only accountable to regulators, this could create ‘moral hazard’ which is a change in behaviour resulting from changes to risk exposure. Shareholders could view the regulator as bringing all companies up to a minimum standard of corporate governance - when this is not the case - and so governance may become less of a differentiator between firms. Codes can help to avoid this as investors will look to the corporate governance metrics of companies and use this as part of their investment decision. This will also drive better corporate behaviour.

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14 See Petow 2007
15 See Pierce 2010
6. **Codes help standards of corporate governance converge between countries**

As the main group holding boards to account, shareholders take the lead in driving best practice. Their activity at international level can act as a converging force on the quality of corporate governance as countries seeking international investment adopt what those investors see as best practice, but in a way that adapts them to their local needs and economy. Indeed, the latest pan-European study found that corporate governance frameworks were converging across the EU\textsuperscript{16}.

In Europe, a study of 300 companies in 17 countries also found convergence. Ratings for board structure and functioning, and particularly for disclosure, have risen in every country and industry. However, shareholders’ rights and duties and takeover defences have not changed significantly\textsuperscript{17}. This may be an area to focus on in the future.

Global investors can add value by pushing for best practice in countries that do not have sufficient local investor power or the capital markets to develop their codes and standards.

7. **Codes incentivise innovation and encourage thought leadership**

Flexibility of codes drive an intelligent and healthy debate within companies about what would constitute good governance, rather than an unthinking compliance mind set.

This enables companies to pay greater attention and care to governance issues. Codes provide flexibility for companies to justify why they have not met a specific provision by providing an explanation which can take the form of an alternative approach. However, the underlying principle of the code must be met. This approach incentivises innovation in governance practices in a way which is adaptive and may develop best practice further. Alternative approaches to meeting the requirements of codes are beneficial as they are tailored specifically to the circumstances of the individual company. This is likely to yield efficient outcomes.

8. **Codes are less costly than law**

Codes can be less costly than a rules based system. Companies have the incentive to assess the relative costs and benefits of standards through the flexibility of codes.

\textsuperscript{16} See Riskmetrics 2009
\textsuperscript{17} See Wojcik 2006.
However, the justification of not applying the code will need to be given to shareholders and therefore must be credible. With rules, standards are applied without direct regard to cost for specific companies and the likelihood of disproportional impact across different companies. Without proportionality, the system is not only inefficient but companies will also be more likely to seek ways of getting around best practice, creating a culture of avoiding corporate governance measures.

Studies have found that the cost of Section 404 of the US Sarbanes Oxley Act (SOX) exceeded its benefits in its initial years. This explains why the majority of companies were initially negative toward it. SOX was seen as having a positive influence only in later years when the front loaded costs were overcome.

Based on costs from SOX\(^\text{18}\), a similar approach in the UK's largest firms would cost, on average, £2.18 million per company in the first year. This would place total cost for the top 200 FTSE companies by market capitalisation at around £436 million. Additional costs to the economy through de-registration and loss of economic output would increase the total cost to the European and global economy.

As in the US, these costs would most likely decline quickly in the UK as companies adapt and reduce associated overheads. However, the value added of rules over codes is not proven. Codes can achieve good outcomes without these costs and are also flexible enough to benefit smaller companies.

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\(^{18}\) FRC calculations based on average cost of SOX per firm. FEI survey is available at: [http://www2.financialexecutives.org/files/spacer.cfm?file_id=1498](http://www2.financialexecutives.org/files/spacer.cfm?file_id=1498)
Four - Conclusion

This paper has shown that there are a number of key components necessary to make corporate governance work effectively. Shareholders must have appropriate rights but must also be able and willing to take forward their duty of stewardship. Companies must engage with shareholders to maintain a system of checks and balances which are conducive to the long term sustainability of business but must also adhere to the principles of best practice and not treat it as a box-ticking exercise.

These key components are shown to be well grounded within a principle-based system which is based on proportionality, flexibility and targeting that cannot be achieved through a one size fits all approach. The paper underscores the need to promote freedom of choice in achieving best practice, whilst at the same time enforcing necessary standards through regulation. At this critical juncture in a period of economic recovery, a continued focus on flexibility is appropriate.

Codes provide this flexibility. They encourage a better corporate behaviour and raise the overall standards of best practice. By evolving over time to meet the needs of business and by doing so at lower cost whilst also remaining receptive to the needs of different businesses, codes are effective in changing behaviour. Finally, codes encourage companies to innovate through alternative measures and also reduce the risk of moral hazard by promoting shareholder engagement.

Total compliance to the letter of corporate governance standards is not the right test for judging effective governance; continuous improvement of behaviours and standards in pursuit of achieving best practice is. Companies and regulators would do well to focus on this and shareholders would do well to encourage them.
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